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Report of the
**Auditor General
of Canada**
to the House of Commons

Foreword and Main Points



April 1998

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Auditor General
of Canada
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AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

To The Honourable the Speaker of the House of Commons:

I have the honour to transmit herewith my first Report of 1998 to the House of Commons, to be laid before the House in accordance with the provisions of section 7(5) of the *Auditor General Act*.

A handwritten signature in dark ink, reading "L. Denis Desautels".

L. Denis Desautels, FCA
Auditor General of Canada

OTTAWA, 28 April 1998

April 1998

Foreword and Main Points

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Report of the Auditor General to the House of Commons for April 1998

Foreword

I am pleased to present the April volume of my 1998 Report. Bound with this Foreword are the Main Points of nine chapters, which are issued separately:

1. Expenditure and Work Force Reductions in the Public Service
2. Expenditure and Work Force Reductions in Selected Departments
3. National Defence — Equipping and Modernizing the Canadian Forces
4. National Defence — Buying Major Capital Equipment
5. Revenue Canada, Department of Finance and Department of Justice — Interdepartmental Administration of the Income Tax System
6. Population Aging and Information for Parliament: Understanding the Choices
7. Federal Laboratories for Human and Animal Health Building Project
8. Department of Finance — Effectiveness Measurement and Reporting
9. Reporting Government Financial Results: The Importance of Complying with Objective Accounting Standards

Government-wide expenditure reductions over the last few years have left many departments with fewer resources and less flexibility to meet new and changing priorities. This Report notes that departments are having to make more difficult choices among programs and projects they fund, practices and processes they follow, and services they provide or the ways they provide them.

In this environment, it is more important than ever that spending choices be made on the basis of solid information. Decision makers need to research the costs, benefits and risks associated with various options before they commit scarce funds to major purchases. Clear performance standards must be set, and ongoing monitoring is needed to ensure that those standards are met along the way. Various chapters in the Report discuss these aspects of several major government projects.

Other countries have preceded Canada in the streamlining of government, and their experience provides useful lessons that could be adapted to Canadian efforts. These are also noted in some of the chapters.

And finally, certain chapters comment on the need for the government to provide solid and objective financial information that Canadians, and Canada's partners, can count on when they make decisions whose impacts will continue for decades to come.



Expenditure and Work Force Reductions in the Public Service

Chapter 1 – Main Points

1.1 Expenditure and work force reductions have affected the public service and public servants for more than a decade. In 1995, the government launched Program Review, an initiative aimed at rethinking and realigning government programs in light of fiscal restraints.

1.2 To better manage expenditure and work force reductions, central agencies moved from imposing, directing and prescribing to providing leadership, guidance and support to departments. For example, instead of adopting the “one size fits all” approach, Treasury Board Secretariat proposed a management and accountability framework to departments and allowed incentive programs to take into account the differences in their context and operational environment.

1.3 Program Review was a success from many perspectives. The deficit has been reduced and personnel costs have decreased for the first time in more than a decade. In spite of a difficult climate, reductions were implemented without major work disruptions; and financial departure incentives have been effective in minimizing layoffs.

1.4 The cost of achieving work force reductions was high, however, not only in dollar terms but in human terms as well. For example, between 1992 and 1997 the government paid incentives to some 46,000 public servants, military and RCMP members to leave or retire. Furthermore, work force reductions have amplified a number of human resource issues, such as the need for rejuvenation and renewal and the need to modernize and simplify human resource systems. Many studies and our own audit work indicate that the public service is an institution under significant stress and that strong actions are now required.

1.5 Significant improvements were made in the management framework put in place by central agencies. Nonetheless, more efforts are needed to improve the management of work force reductions — for example, in critical occupational groups where there might be surpluses in some departments but shortages in others.

1.6 There is a need to improve accountability to Parliament for expenditure and work force reductions, and for the related costs. Roles, responsibilities and accountabilities of central agencies and departments in the management of work force reductions also need to be clarified.



Expenditure and Work Force Reductions in Selected Departments

Chapter 2 – Main Points

2.1 As a result of a lengthy period of fiscal restraint and recent expenditure reduction programs, some federal government agencies have been abolished, some departments merged and others reduced in size. It is estimated that the public sector work force will have been reduced by approximately 45,000 employees between April 1995 and March 1998.

2.2 We selected seven departments to examine how and the extent to which expenditure reductions have been implemented. These organizations, representing over 170,000 employees, differed in size, structure and reduction targets.

2.3 Generally, departments we reviewed met their 1995–96 and 1996–97 expenditure and work force reduction requirements. Given progress to date, we expect that most of them will meet their reduction targets for the remaining two years of Program Review.

2.4 We found that ministerial commitment and departmental leadership were evident in setting direction and attaining momentum. Factors such as the size of the reduction, readiness for change and the time available to plan had an effect on departments' strategic planning for reduction. Departmental implementation of reduction was generally rigorous and employees were well informed both prior to and during the reduction process.

2.5 Although most reduction targets were met, and overall compliance with work force reduction policies had improved since our 1992 Report chapter, Payments to Employees under the Work Force Adjustment Policy, we found questionable actions in some departments. The need for incentive packages was not always well researched and there was a tendency to call for volunteers prior to identifying positions surplus to requirement. Best practices suggest that an organization should conduct a thorough cost/benefit analysis of alternatives; target incentives to areas where they are needed most; and identify the extent to which there is a need to call for volunteers.

2.6 Departments focussed primarily on meeting reduction targets in a timely manner. Less emphasis was placed on cost management. Such factors as the initial lack of necessary financial and human resource information, departments not having to fund entirely the departure incentives they provided, and an unclear Treasury Board Secretariat accountability structure for departmental work force reduction costs contributed to a general lack of cost consciousness in departments.

2.7 Throughout work force reduction, departments treated departing employees in a humane and sensitive manner. Departments paid less attention generally to those who remained and to their concerns regarding the loss of experienced and qualified colleagues, the level of workload per employee and future departmental direction. Departments have now entered a period of transition that will require not only adjusting organizational structures and operations but also paying particular attention to ensuring that work force capability meets future operational demands.



National Defence —

Equipping and Modernizing the Canadian Forces

Chapter 3 – Main Points

3.1 A modern, multi-purpose, combat-capable force able to “fight alongside the best, against the best” is necessary to fulfil Canada’s defence policy commitments, although the policy does not require the Canadian Forces to possess every component of military capability.

3.2 According to Department of National Defence officials, Canada’s White Paper commitments are defined by the defence capabilities of the Canadian Forces. We found many equipment deficiencies that limit capabilities.

3.3 If the status quo persists, the Department’s available capital funding may not be sufficient to equip and modernize the force that National Defence is currently planning. Officials told us that they expect to be able to increase the capital portion of the budget. Nevertheless, they anticipate that hard choices may have to be made.

3.4 Personnel, operations and maintenance costs are rising, which is further reducing the portion of the budget available for capital equipment.

3.5 We found that the Department does not have an adequate policy framework to direct the almost \$1.4 billion it spends each year on equipment modernization. It does not yet have in place fully developed operational scenarios to guide planners, or performance information that identifies gaps.

3.6 Some other countries — notably the United States and New Zealand — have taken the lead in the way their government budgeting and management systems actively manage defence policy and resources.

Chapter 4 – Main Points

4.1 National Defence plans to spend almost \$6.5 billion over the next five years to purchase equipment that Canada's armed forces need to carry out their assigned tasks. As Chapter 3 indicates, the Department's available capital funding may not be sufficient to equip and modernize the force that is currently planned.

4.2 This chapter reports our findings on the management of six major capital projects with a total value of \$3.3 billion.

4.3 All six projects we examined are likely to meet their contract cost and performance objectives. For example, the Eryx anti-tank missile system and the Coyote reconnaissance vehicle appear to perform especially well and have attracted the interest of foreign armed services. Nevertheless, we are concerned about several of the management practices we observed.

4.4 We found that defence policy allows wide latitude in the level of equipment capability required. We noted in the projects we examined that affordability constraints resulted in only low-end capability being purchased, limitations in the number purchased, or both:

- the Maritime Coastal Defence Vessel is acquiring two sets of mechanical minesweeping gear for 12 ships effective only against some types of mines, and has not acquired some of the equipment necessary to patrol effectively in darkness and poor visibility;
- the Leopard C1 tank is being fitted with only an improved sight, although the army had considered a complete upgrade, including the gun and armour, to be the "minimum viable" option;
- the Griffon helicopter cannot meet the army's original lift and communications requirements;
- fewer Eryx missiles and Coyote vehicles have been purchased than were originally intended.

4.5 We are concerned at the extent to which the Department relies on professional judgment in making complex purchase decisions. Management did not conduct adequate analyses to justify its spending decisions for most of the projects we examined. Tactical studies often did not reflect the way officials said they actually planned to employ equipment, were done too late to influence decisions, produced results that contradicted the purchase decision, were undertaken by contractors who had an interest in the Department's decision, or were not done at all.

4.6 In three cases, the Department considered only a single option. In other cases, the options analyses were inadequate.

4.7 Only one project of the six fully met our expectations for a rigorous risk management process. No project we examined has suffered major problems so far because of this, but we identified several instances where better risk management might have improved project delivery.

Chapter 4 – Main Points (cont'd)

4.8 Although test and evaluation processes were satisfactory in most cases, for some of the projects that involved commercially based designs, the equipment was not tested under actual operating conditions until after it had been introduced into service. Problems have since been discovered that have affected the operational capability of some of the equipment. The Department is currently working to resolve these problems.

4.9 The Department began a major management renewal program in 1994 that included the capital acquisition process. Because it considered other areas to be more important, it deferred work on capital equipment acquisition and it does not yet have an implementation plan. The Department has begun work on the plan, including three pilot projects. Because equipment acquisition is a government-wide process, the Department is working with Public Works and Government Services Canada, Industry Canada, and the private sector to improve government practices. We believe the departments concerned must develop a plan with definite dates and milestones to complete their reform process.



Revenue Canada, Department of Finance and Department of Justice

Interdepartmental Administration of the Income Tax System

Chapter 5 – Main Points

5.1 Three departments play a key role in administering the income tax system. The Department of Finance is responsible for the formulation of tax policy and the introduction of new tax legislation, Revenue Canada oversees the administration of tax laws and the Department of Justice provides legal advisory services and litigation services to both Finance and Revenue Canada.

5.2 Efficient and effective relationships among Revenue Canada, the Department of Justice and the Department of Finance are essential for the smooth functioning of the income tax system. This audit was undertaken because our past work had raised some concerns about the management of risk to the tax base. Our current examination found that the departments have taken many important measures to improve their relationships. We have been told that the proposed change of Revenue Canada to a new Canada Customs and Revenue Agency will not affect their relationships.

5.3 An important aspect of managing the risk to the tax base is the identification and correction of legislative deficiencies. We found that Revenue Canada and the Department of Justice regularly bring deficiencies to the attention of the Department of Finance. However, the correction of legislative deficiencies is left to the discretion of the Department of Finance.

5.4 As all three departments are key players in managing the risks arising from legislative deficiencies, it is important that they all be involved in deciding which deficiency should be given priority.

5.5 The management of tax litigation risks has been improved. However, Revenue Canada and the Department of Justice need to strengthen the partnership arrangement for planning litigation needs and managing the risks.

5.6 Settlements of income tax disputes resolved through consent judgments have been made on a mix of law and facts. Revenue Canada should provide transparency in the settlement agreements it undertakes. As an example, United States income tax law provides public access to settlement agreements, with privacy protection of the taxpayer's identity.



Population Aging and Information for Parliament: Understanding the Choices

Chapter 6 – Main Points

6.1 Canada today is sitting on a very favourable demographic structure, with a historically low ratio of youth and elderly to the working-age population. In the coming few decades, this situation will be radically transformed. By the second decade of the next century, when the leading edge of the baby boom generation reaches normal retirement age, the growth in Canada's elderly population will accelerate while that of the working-age population will slow to a crawl.

6.2 This demographic shift has the potential to affect government finances in a significant way. An aging population puts pressure on government spending through higher pension payments and increased demands for health care services. Also, unless there are significant changes in the patterns of work, this demographic change will reduce labour force growth dramatically, which in turn would slow down economic growth and, with that, the growth in government revenues. This combination could put enormous pressures on our public finances when the full impact of this demographic change is felt by the second decade of the next century, particularly if Canada's debt burden and tax levels remain high.

6.3 The government is well aware of these pressures; during consultations on reforming specific programs like the Canada Pension Plan, it provided detailed projections of the effects of demographic forces on CPP finances. This longer-term information not only helped inform public debate, but also motivated acceptance of the need for change. To a lesser extent, as government began discussing reforms to Old Age Security and the Guaranteed Income Supplement (the Seniors Benefit), it again provided longer-term projections of the financial impacts.

6.4 Yet what it has done to highlight the impact of demographics on the financial health of individual programs, it has failed to do for the financial health of the government as a whole. Consequently, parliamentarians are left to make annual financial decisions, many of which have lasting consequences, without a macro perspective — a summing up of the financial impacts that demographics can potentially have on the government's long-term financial health.

6.5 The importance of appropriate information to help parliamentarians understand the government's financial condition is clearly a responsibility and a theme on which we have reported over the last six years. This chapter, illustrating the feasibility of preparing such longer-term information and the significance of that information, is a continuum of the "Information for Parliament" chapters in our 1993 and 1995 Reports. The particular contribution of this chapter is its focus on the role of demographics in assessing the government's financial condition.



Federal Laboratories for Human and Animal Health Building Project

Chapter 7 – Main Points

7.1 The new Federal Laboratories for Human and Animal Health in Winnipeg contain some of the most advanced diagnostic, research and training facilities of their kind in the world. The facility is the first in the world to combine laboratories concerned with both human and animal diseases, and the first in Canada capable of handling the most dangerous viruses known. The facility is to be used by Health Canada and the Canadian Food Inspection Agency.

7.2 International experts involved in reviewing the design and construction of the facility have noted that it is extremely secure with regard to containment of biohazardous materials.

7.3 Despite a lengthy history of project proposals by Agriculture and Agri-Food Canada and Health Canada to construct new laboratory facilities, the Winnipeg project was undertaken without adequate analyses of existing laboratory capacity. The Winnipeg facility currently has space that exceeds its planned program needs and the amount approved by Treasury Board, and that has added to a national inventory of surplus laboratory capacity.

7.4 Health Canada and the Canadian Food Inspection Agency have informed us that they recognize the importance of ensuring that the facility is fully used, including the need to explore potential cost-recovery opportunities. To date, however, a comprehensive business plan and strategy for achieving these aims has not been developed.

7.5 In our opinion, the project is approximately 12 months behind schedule and could have been delivered for at least \$5 million to \$10 million less. In addition, the approved project budget of \$141.8 million does not accurately reflect the project's total cost to the taxpayer, currently estimated at \$176 million. The proposed project budget did not identify all project costs, as required by Treasury Board policy.

7.6 We identified several areas where Public Works and Government Services Canada can improve its practices in selecting and managing consultants on future complex projects like this one. We also noted that shared authority and accountability require careful management to mitigate risks of project delays and added costs.

7.7 As we have noted in reviewing other government projects, the current "build [up] to budget" approach, the lack of systemic incentives for seeking cost savings within approved budgets, and the absence of a departmental culture that supports such aims do not encourage the parties to identify and realize potential cost savings.

7.8 The new facility is a potential source of pride for all Canadians as it contributes to the global effort to identify and combat human and animal infectious diseases. Due to the nature of its programs, the Winnipeg laboratories will be expensive to operate and maintain. The challenge for Health Canada and the Canadian Food Inspection Agency will be to ensure that the full potential of this new facility is achieved.



Department of Finance —

Effectiveness Measurement and Reporting

Chapter 8 – Main Points

8.1 In addition to functions that include preparing the Budget and providing economic policy advice to the government, the Department of Finance has responsibilities related to a number of policies and programs. The Department's 1997–98 planned expenditures of \$66 billion account for 43 percent of planned federal expenditures. The Department is also responsible for federal tax policy, including preferential tax provisions that are intended to lead to the achievement of a variety of government policy objectives.

8.2 The significance of the Department's policy and program responsibilities underlines the importance of its obligation to make known to Parliament and to the public, in a clear and meaningful manner, the nature and extent of those responsibilities, the objectives involved and the results achieved relative to those objectives.

8.3 Improvement is required in providing Parliament with clear and consistent statements of objectives and of the Department's policy and program-related responsibilities. For many policies and programs, the Department shares responsibilities with other departments and agencies. We found a general lack of clarity in documents directed to Parliament about the other departments and agencies involved and the manner in which responsibilities are shared.

8.4 We found gaps in reporting to Parliament on results achieved relative to objectives. Our findings in this audit are consistent with the findings of a number of audits of individual policies and programs undertaken by this Office over the past six years. The picture that emerges is one of known shortcomings, and insufficient attention to measuring effectiveness and reporting results to Parliament and the public.

8.5 Legislative provisions governing a number of the Department's policies and programs have been the subject of review by Parliament to consider whether the provisions should be changed to improve performance and to enable policies and programs to be adapted to new circumstances. Such legislative reviews are valuable in their own right; they are not, however, a substitute for systematic measurement and reporting of effectiveness information by the Department. We believe legislative reviews would be enhanced by Parliament having more regular and timely access to information on the results that policies and programs have achieved.

8.6 Planning for effectiveness measurement and reporting is not sufficiently linked with the Department's corporate planning process. The Department's current approach results in an effectiveness measurement function that is partial in coverage and not clearly integrated with the overall corporate management structure. In view of the limited resources allocated specifically to the function, we are concerned about the Department's capacity to meet its obligations to account to Parliament for results achieved.



Reporting Government Financial Results: The Importance of Complying with Objective Accounting Standards

Chapter 9 – Main Points

9.1 The 1980s and early nineties have seen major advances in financial reporting by sovereign governments, with Canada among the leaders. However, over the past two years the Government of Canada has begun departing from both objective accounting standards and its own stated accounting policies for certain transactions. Moreover, the 24 February 1998 Budget indicates that a similar departure will occur in 1998.

9.2 In 1996, transitional assistance for harmonizing PST with GST was included in the deficit even though provinces had not yet agreed to the harmonization by the end of the year. In 1997, funding of the Canada Foundation for Innovation was included in the deficit even though the Foundation did not exist by the end of the year. In 1998, the 24 February 1998 Budget indicates that funding of the Canada Millennium Scholarship Foundation will be included in financial results whether or not the Foundation exists by the end of the year.

9.3 As auditors of the government's financial statements, we are deeply concerned over this recent disregard by the government for objective accounting standards in reporting its financial results to Parliament and to Canadians. This is not merely a technical disagreement between an accountant and an auditor. Objective accounting standards are accepted and identifiable standards that are established by an arm's-length standard-setting body – the Canadian Institute of Chartered Accountants (CICA). Business firms cannot depart from objective accounting standards established by the CICA, to hide losses or to hide profits. Parliamentarians should expect no less from the government.

9.4 Meeting the significant challenges of the next decade will require, among other things, credible annual reports by the government on its overall financial health. In our view, departures from CICA standards and the government's own accounting policies must cease if credibility is to be restored to the reports that parliamentarians and others need.

9.5 Accordingly, we have recommended that the Government of Canada ensure that its accounting policies and practices conform with recommendations issued by the CICA's Public Sector Accounting and Auditing Board. Implementation of this recommendation will require continued diligence by the Public Accounts Committee of the House of Commons in reviewing the government's annual financial statements.

9.6 Although this chapter calls Parliament's attention to inappropriate accounting, there are related concerns that we have and will continue to report separately. They deal with accountability and parliamentary oversight for entities such as the Innovation Foundation and the Millennium Scholarship Foundation, and with whether or not such entities are, in substance, operating at arm's length from the government.

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La présentation des résultats financiers du gouvernement : l'importance de respecter des normes comptables objectives

Chapitre 9 – Points saillants



- 9.1** Les années 80 et le début des années 90 ont été le théâtre de progrès considérables dans la communication de l'information financière par les gouvernements des États souverains. Le Canada comptant parmi les chefs de file. Toutefois, au cours des deux dernières années, le gouvernement du Canada a commencé à déroger tant aux normes comptables objectives qu'à ses propres conventions comptables pour certaines opérations. Qui plus est, le Budget du 24 février 1998 indique qu'une dérogation semblable se produira en 1998.
- 9.2** En 1996, l'aide transitoire à l'harmonisation de la TPS et de la TVP a été incluse dans le déficit, même si les provinces n'avaient pas donné leur accord à l'harmonisation à la fin de l'exercice. En 1997, le financement de la Fondation canadienne pour l'innovation a été inclus dans le déficit, même si la Fondation n'existait pas à la fin de l'exercice. Le Budget du 24 février 1998 indique que le financement de la Fondation canadienne des bourses d'études du millénaire sera inclus dans les résultats financiers, que la Fondation existe ou qu'elle n'existe pas à la fin de l'exercice.
- 9.3** En tant que vérificateurs des états financiers du gouvernement, nous sommes profondément préoccupés du fait que le gouvernement n'a pas observé récemment les normes comptables objectives dans sa communication des résultats financiers au Parlement et aux Canadiens. Il ne s'agit pas simplement d'un désaccord technique entre un comptable et un vérificateur. Les « normes comptables objectives » sont des normes reconnues qui sont établies par un organisme de normalisation indépendant, l'Institut Canadien des Comptables Agréés (ICCA). Les entreprises commerciales ne peuvent déroger aux normes comptables objectives établies par l'ICCA pour cacher des profits ou des pertes. Les parlementaires devraient s'attendre à autant de la part du gouvernement.
- 9.4** Pour relever les défis de taille qui se poseront au cours de la prochaine décennie, le gouvernement devra notamment présenter des rapports financiers annuels crédibles sur sa condition financière globale. À notre avis, les dérogations aux normes de l'ICCA et aux propres conventions comptables du gouvernement doivent cesser pour que soit rétablie la crédibilité des rapports dont les parlementaires et les autres parties ont besoin.
- 9.5** Par conséquent, nous avons recommandé que le gouvernement du Canada fasse en sorte que ses conventions et ses pratiques comptables soient conformes aux recommandations publiées par le Conseil sur la comptabilité et la vérification dans le secteur public de l'Institut Canadien des Comptables Agréés. La mise en oeuvre de notre recommandation exigera du Comité des comptes publics de la Chambre des communes qu'il exerce une diligence continue lorsqu'il examinera les états financiers annuels du gouvernement.
- 9.6** Même si ce chapitre attire l'attention du Parlement sur des aspects de comptabilité inappropriée, nous avons d'autres préoccupations du même ordre et nous continuerons de les communiquer séparément. Ces préoccupations ont trait à la reddition de comptes et à la surveillance parlementaire d'entités comme la Fondation canadienne pour l'innovation et la Fondation canadienne des bourses d'études du millénaire, et à la question de savoir si ces entités fonctionnent, oui ou non, essentiellement de façon indépendante du gouvernement.



Chapitre 8 – Points saillants

8.1 En plus d'exercer des fonctions qui comprennent la préparation du budget et la prestation de conseils en matière de politique économique au gouvernement, le ministère des Finances assume des responsabilités liées à un certain nombre de politiques et de programmes. Les dépenses prévues du Ministère pour 1997-1998 s'élèvent à 66 milliards de dollars, ce qui représente 43 p. 100 des dépenses fédérales prévues. Le Ministère est également responsable de la politique fiscale fédérale, y compris les dispositions fiscales préférentielles destinées à conduire à la réalisation de divers objectifs prévus par les politiques du gouvernement.

8.2 La portée des responsabilités du Ministère en matière de politiques et de programmes met en relief l'importance de son obligation de faire connaître au Parlement et au public, de façon claire et significative, la nature et l'étendue de ces responsabilités, les objectifs visés et les résultats atteints par rapport à ces objectifs.

8.3 Il y a lieu de fournir au Parlement des énoncés plus clairs et plus cohérents sur les objectifs et les responsabilités du Ministère en matière de politiques et de programmes. Dans nombre de politiques et de programmes, le Ministère partage des responsabilités avec d'autres ministères et organismes. Nous avons constaté un manque général de clarté dans les documents fournis au Parlement quant aux autres ministères et organismes concernés et quant à la manière dont les responsabilités sont partagées.

8.4 Nous avons constaté des lacunes dans les rapports qui présentent au Parlement les résultats obtenus comparativement aux objectifs fixés. Les constatations de la présente vérification rejoignent celles d'un certain nombre de vérifications de politiques et de programmes effectuées par le Bureau au cours des six dernières années. L'image qui se dégage se caractérise par des lacunes déjà connues et par le caractère insuffisant de l'attention portée à la mesure de l'efficacité et à la communication des résultats au Parlement et au public.

8.5 Les dispositions législatives qui régissent un certain nombre de politiques et de programmes relevant du Ministère ont été examinées par le Parlement pour déterminer si elles doivent être modifiées afin d'améliorer le rendement et de permettre l'adaptation des politiques et des programmes à l'évolution des circonstances. Ces examens législatifs sont précieux en eux-mêmes, mais ils ne sauraient remplacer, au Ministère, la mesure et l'information méthodiques en matière d'efficacité. Nous croyons que les examens législatifs seraient renforcés si le Parlement avait un accès régulier et en temps opportun à de l'information sur les résultats obtenus par les politiques et les programmes.

8.6 La planification de la mesure de l'efficacité et de la reddition de comptes n'est pas suffisamment liée au processus de planification institutionnelle du Ministère. La méthode actuellement suivie par le Ministère a pour conséquence que la fonction de mesure de l'efficacité a une portée partielle et n'est pas clairement intégrée dans la structure globale de gestion institutionnelle. Compte tenu du caractère limité des ressources affectées spécifiquement à cette fonction, nous sommes inquiets quant à la capacité du Ministère à s'acquitter de son obligation de rendre compte au Parlement des résultats obtenus.



Chapitre 7 – Points saillants

7.1 Le nouveau complexe de laboratoires fédéraux de santé humaine et animale de Winnipeg abrite des installations de diagnostic, de recherche et de formation parmi les plus modernes au monde dans leur catégorie. Le complexe est le premier dans le monde à réunir des laboratoires qui s'occupent à la fois des maladies de l'homme et de l'animal, et le premier au Canada dont l'aménagement permet la manipulation des virus les plus dangereux que l'on connaisse. Santé Canada et l'Agence canadienne d'inspection des aliments utiliseront ce complexe.

7.2 Les spécialistes internationaux qui ont participé à l'examen des critères de conception et de construction du complexe ont jugé celui-ci extrêmement sécuritaire en ce qui concerne le confinement des dangers biologiques.

7.3 Malgré la longue série de propositions présentées par Agriculture et Agroalimentaire Canada et Santé Canada en rapport avec la construction de nouveaux laboratoires, le projet de Winnipeg a été entrepris sans que l'on ait suffisamment analysé la capacité de laboratoire actuelle. Le complexe de Winnipeg possède présentement des aires de laboratoire qui dépassent les exigences prévues de ses programmes et le montant autorisé par le Conseil du Trésor; cela s'ajoute à un inventaire national de capacité excédentaire.

7.4 Santé Canada et l'Agence canadienne d'inspection des aliments nous ont fait savoir qu'ils sont conscients de l'importance de tirer pleinement parti du complexe et d'explorer toutes les options permettant un recouvrement des coûts. Cependant, à ce jour, on n'a élaboré aucune stratégie ni aucun plan d'entreprise exhaustifs en vue d'atteindre ces buts.

7.5 À notre avis, le projet accuse un retard d'environ 12 mois sur l'échéancier et il aurait pu être réalisé pour au moins cinq à dix millions de dollars de moins. De plus, le budget de 141,8 millions de dollars ne reflète pas exactement le coût total du projet pour le contribuable, présentement estimé à 176 millions de dollars. Le budget proposé ne faisait pas état de tous les coûts reliés au projet, tel que l'exige la politique du Conseil du Trésor.

7.6 Nous avons cerné plusieurs domaines où Travaux publics et Services gouvernementaux Canada peut améliorer ses pratiques de sélection et de gestion des consultants auxquels des projets complexes comme celui-ci seront confiés à l'avenir. Nous avons aussi constaté que le partage du pouvoir et de l'obligation de rendre compte exigent une gestion prudente pour atténuer les risques de retards des projets et de surcoûts.

7.7 Comme nous l'avons constaté lors de l'examen d'autres projets publics, la démarche actuelle qui pousse à « construire jusqu'à la limite du budget », un système qui ne comporte pas d'encouragements systémiques à faire des économies dans les limites des budgets approuvés, et l'absence de culture ministérielle qui appuierait ce genre d'objectif sont autant de facteurs qui n'ont pas incité les parties à envisager et à appliquer des options permettant de réaliser des économies.

7.8 Le nouveau complexe est une réalisation dont tous les Canadiens pourront tirer fierté puisqu'elle concourt à l'effort mondial de dépistage des maladies humaines et animales infectieuses et de lutte contre celles-ci. En raison de la nature de leurs programmes, les laboratoires de Winnipeg seront coûteux à exploiter et à entretenir. Pour Santé Canada et l'Agence canadienne d'inspection des aliments, le défi qui se pose maintenant est de tirer pleinement parti de ce nouveau complexe.

Chapitre 6 – Points saillants



Le vieillissement de la
population et l'information
destinée au Parlement : pour
comprendre les choix

6.1 Le Canada jouit actuellement d'une structure démographique très favorable, qui se caractérise d'un point de vue historique par un rapport peu élevé des jeunes et des personnes âgées à la population d'âge actif. Au cours des décennies à venir, la situation connaîtra un changement radical. Dès la deuxième décennie du siècle prochain, lorsque les premiers-nés de la génération issue de l'explosion démographique auront atteint l'âge normal de la retraite, la croissance de la population âgée du Canada prendra de la vitesse alors que celle de la population d'âge actif ralentira énormément.

6.2 Ce changement démographique pourrait avoir des effets néfastes sur les finances publiques. Le vieillissement de la population se traduit par des pressions sur les dépenses publiques, sous l'effet de l'accroissement des versements au titre des pensions de retraite et de la demande à l'égard des services de soins de santé. De plus, à moins d'une importante transformation des systèmes de travail, ce changement démographique amortira considérablement la croissance de la population active, ce qui aura pour effet de ralentir la croissance économique et, par conséquent, la croissance des recettes publiques. Cette combinaison de facteurs pourrait être lourde de conséquences pour les finances publiques, lorsque tous les effets du changement démographique se feront sentir, d'ici la deuxième décennie du siècle prochain, et en particulier si le fardeau de la dette et les niveaux d'imposition du Canada demeurent élevés.

6.3 Le gouvernement n'ignore pas ces pressions démographiques; pendant les consultations tenues sur la réforme de programmes précis comme le Régime de pensions du Canada, il a diffusé des projections détaillées des effets des forces démographiques sur la situation financière du régime. Cette information à long terme non seulement a alimenté le débat public, mais elle a aussi fait accepter la nécessité de changements. Lorsque le gouvernement a commencé à discuter des mesures de réforme à apporter à la Sécurité de la Vieillesse et au Supplément de revenu garanti (Prestation aux aînés), il a de nouveau diffusé des projections à long terme de l'incidence financière des réformes, bien que dans une moindre mesure.

6.4 Pourtant, ce qu'il a fait pour souligner l'incidence des facteurs démographiques sur la santé financière de chacun des programmes, il a omis de le faire pour la santé financière du gouvernement dans son ensemble. Par conséquent, les parlementaires sont appelés à prendre des décisions financières annuelles, dont beaucoup ont des conséquences à long terme, sans pour autant pouvoir s'appuyer sur une perspective globale — une récapitulation des effets que les facteurs démographiques pourraient avoir sur la santé financière à long terme du gouvernement.

6.5 La nécessité de diffuser de l'information pertinente afin d'aider les parlementaires à bien saisir la situation financière du gouvernement est une responsabilité et un thème sur lesquels nous avons insisté au cours des six dernières années. Le présent chapitre, qui montre qu'il est possible de communiquer de l'information à long terme, en insistant sur l'importance d'une telle information, fait suite aux chapitres « Information destinée au Parlement » des rapports de 1993 et de 1995. Le présent chapitre se distingue par l'accent mis sur le rôle des facteurs démographiques dans l'évaluation de la situation financière du gouvernement.

Revenu Canada, ministère des Finances et ministère de la Justice L'administration interministérielle du régime d'impôt sur le revenu



Chapitre 5 – Points saillants

5.1 Trois ministères jouent un rôle de premier plan dans l'administration du régime d'impôt sur le revenu. Le ministère des Finances est chargé de formuler la politique fiscale et de présenter les nouvelles dispositions législatives concernant l'impôt; Revenu Canada voit à l'application des lois fiscales et le ministère de la Justice assure des services juridiques consultatifs et le contentieux à la fois pour le ministère des Finances et pour Revenu Canada.

5.2 Des relations efficaces et efficaces entre Revenu Canada, le ministère de la Justice et le ministère des Finances sont indispensables au fonctionnement harmonieux du régime d'impôt sur le revenu. Nous avons entrepris la présente vérification parce que nos travaux antérieurs avaient révélé des motifs d'inquiétude quant à la gestion des risques pour l'assiette fiscale. L'examen dont nous rendons compte ici nous a permis de constater que les trois ministères ont pris beaucoup de mesures importantes pour améliorer leurs relations. On nous a dit que la transformation projetée de Revenu Canada en Agence canadienne des douanes et du revenu n'affecterait en rien ces relations.

5.3 Déceler et combler les lacunes législatives constitue un élément majeur de la gestion des risques pour l'assiette fiscale. Nous avons constaté que Revenu Canada et le ministère de la Justice portent régulièrement de telles lacunes à l'attention du ministère des Finances. Toutefois, la décision de combler les lacunes législatives est laissée à la discrétion du ministère des Finances.

5.4 Puisque les trois ministères jouent un rôle prépondérant dans la gestion des risques qui découlent des lacunes législatives, il importe que les trois prennent part au choix des questions qui devraient recevoir la priorité.

5.5 La gestion des risques liés au contentieux fiscal a été améliorée. Toutefois, Revenu Canada et le ministère de la Justice devraient renforcer leur entente de partenariat visant la planification des besoins en matière de contentieux et la gestion des risques connexes.

5.6 Des différends relatifs à l'impôt sur le revenu ont été réglés au moyen de jugements convenus, en fonction de principes de droit combinés à des faits. Revenu Canada devrait donner accès à l'information concernant les ententes de règlement qu'il conclut. Par exemple, la législation des États-Unis en matière d'impôt sur le revenu prévoit que le public doit avoir accès à l'information sur les ententes de règlement, une fois retirées les indications relatives à l'identité du contribuable pour protéger sa vie privée.

Chapitre 4 – Points saillants (suite)

4.7 Sur les six projets, un seul a répondu à nos attentes en ce qui concerne l'établissement d'un processus rigoureux de gestion des risques. Jusqu'ici, aucun des projets que nous avons examinés n'a été sérieusement compromis à cause de cela, mais nous avons relevé plusieurs cas où une meilleure gestion des risques aurait pu améliorer l'exécution du projet.

4.8 Les processus d'essai et d'évaluation ont été satisfaisants dans la plupart des cas. Cependant, dans certains projets portant sur des équipements de modèle commercial, ce n'est qu'après leur mise en service que les équipements en question ont été testés dans des conditions d'utilisation réelles. Depuis, on a découvert des problèmes qui ont affecté la capacité opérationnelle de certains de ces équipements. Le Ministère s'efforce actuellement de résoudre ces problèmes.

4.9 En 1994, le Ministère a entrepris un vaste programme de renouveau de la gestion qui incluait la gestion de l'acquisition des biens d'équipement. Parce que d'autres questions étaient jugées plus importantes, le Ministère a retardé l'examen de ce dernier secteur, examen pour lequel n'existe pas encore de plan de mise en oeuvre. Le Ministère a entrepris l'élaboration d'un plan qui comporte notamment trois projets pilotes. L'acquisition de biens d'équipement étant un processus d'envergure gouvernementale, le Ministère, en collaboration avec Travaux publics et Services gouvernementaux Canada, Industrie Canada et le secteur privé, s'efforce d'améliorer les pratiques gouvernementales. Nous croyons que les ministères intéressés doivent établir un plan comportant des échéances précises pour mener à bien leur processus de réforme.



Chapitre 4 – Points saillants

4.1 Le ministère de la Défense nationale (MDN) prévoit dépenser près de 6,5 milliards de dollars au cours des cinq prochaines années pour acheter les biens d'équipement dont les Forces armées canadiennes ont besoin pour remplir les tâches qui leur sont confiées. Comme nous l'indiquons au chapitre 3, le budget dont dispose le Ministère à cette fin ne sera peut-être pas suffisant pour équiper et moderniser la force prévue actuellement.

4.2 Le présent chapitre expose nos constatations sur la gestion de six grands projets d'acquisition de biens d'équipement d'une valeur totale de 3,3 milliards de dollars.

4.3 Pour chacun des six projets que nous avons examinés, il est probable que les objectifs de coût et de rendement établis dans le contrat seront atteints. Par exemple, le missile antichar Eryx et le véhicule de reconnaissance Coyote semblent fonctionner particulièrement bien, et des forces armées étrangères s'y intéressent. Néanmoins, plusieurs pratiques de gestion que nous avons observées nous semblent préoccupantes.

4.4 Nous avons constaté que la politique de défense laisse beaucoup de latitude au Ministère lorsqu'il s'agit de déterminer le niveau d'équipement requis. De plus, nous avons constaté, pour ce qui est des projets examinés, que le manque de moyens financiers a mené à l'achat de matériel bas de gamme seulement et/ou à des restrictions quant au nombre d'articles achetés :

- Pour 12 de ses navires de défense côtière, le Ministère a acheté deux unités d'un dispositif de dragage mécanique qui n'est efficace que contre certains types de mine. De plus, il n'a pas acheté tout l'équipement dont ces navires auraient besoin pour patrouiller efficacement la nuit et dans des conditions de faible visibilité.
- Le char Leopard C1 n'a été doté que d'un viseur amélioré, bien que l'armée de terre ait établi qu'une modernisation complète (y compris celle du canon et du blindage) constituait le « minimum acceptable ».
- L'hélicoptère Griffon ne peut pas répondre aux exigences initiales de l'armée de terre en ce qui concerne la capacité d'emport et le matériel de communications.
- Dans le cas du système d'arme Eryx et des véhicules Coyote, le Ministère a acheté moins d'unités que ce qui était prévu initialement.

4.5 Nous sommes inquiets de la mesure dans laquelle le Ministère se fie au jugement professionnel de son personnel lorsqu'il prend des décisions complexes d'achat. Dans la plupart des projets que nous avons examinés, la direction n'a pas effectué d'analyses adéquates pour justifier ses décisions d'achat. Dans bien des cas, les études tactiques n'ont pas tenu compte de l'usage que l'on voulait faire de l'équipement au Ministère, ont été faites trop tard pour influencer les décisions, ont produit des résultats contraires à ceux que prévoyait la décision d'achat, ont été menées par des entrepreneurs qui avaient un intérêt dans la décision du Ministère, ou n'ont pas été faites du tout.

4.6 Dans trois cas, le Ministère a examiné une seule option. Dans d'autres cas, l'analyse des options a été inadéquate.



Chapitre 3 – Points saillants

3.1 Une force moderne, polyvalente et apte au combat, capable de « se battre aux côtés des meilleurs, contre les meilleurs », voilà ce dont le Canada a besoin pour remplir les engagements de sa politique de défense. Celle-ci n'exige pas toutefois que les Forces canadiennes possèdent tous les éléments de la panoplie militaire.

3.2 Selon les représentants du ministère de la Défense nationale, les engagements pris dans le Livre blanc du Canada sont définis en fonction des capacités de défense des Forces canadiennes. Or, nous avons constaté, sur le plan de l'équipement, de nombreuses lacunes qui restreignent ces capacités.

3.3 Si le statu quo persiste, les fonds dont le Ministère dispose pour les dépenses en capital ne seront peut-être pas suffisants pour équiper et moderniser la force, comme le prévoit actuellement la Défense nationale. Les responsables nous ont indiqué qu'ils devraient être en mesure d'accroître la part du budget consacrée aux dépenses en capital. Néanmoins, ils s'attendent à ce qu'il faille procéder à des choix difficiles.

3.4 Les coûts liés au personnel, au fonctionnement et à l'entretien sont à la hausse, ce qui réduit davantage la portion du budget consacrée aux biens d'équipement.

3.5 Nous avons constaté que le Ministère n'a pas de cadre stratégique adéquat pour administrer le montant de quelque 1,4 milliard de dollars qu'il dépense chaque année afin de moderniser l'équipement. Il n'a pas encore de scénarios opérationnels bien établis pour orienter les planificateurs, et il ne dispose pas d'information sur le rendement qui permette de déterminer les écarts.

3.6 Certains pays — notamment les États-Unis et la Nouvelle-Zélande — ont fait figure de proue dans la façon dont les systèmes de budgétisation et de gestion de leur gouvernement assurent une gestion active de la politique et des ressources en matière de défense.

Les réductions des dépenses et des effectifs dans certains ministères



Chapitre 2 – Points saillants

2.1 À la suite d'une longue période de restrictions financières et des récents programmes de réduction des dépenses, quelques organismes fédéraux ont été abolis, certains ministères ont été fusionnés, d'autres ont été comprimés. On estime que les effectifs du secteur public auraient diminué d'environ 45 000 fonctionnaires entre avril 1995 et mars 1998.

2.2 Pour les besoins de nos travaux de vérification sur l'ampleur des réductions des dépenses et sur la façon dont elles ont été appliquées, nous avons choisi sept ministères fédéraux. Ces derniers, qui emploient plus de 170 000 employés, avaient des effectifs, une structure et des objectifs de réduction différents.

2.3 En général, les ministères que nous avons examinés ont effectué les réductions des dépenses et des effectifs voulues en 1995-1996 et en 1996-1997. Compte tenu des progrès qu'ils ont réalisés à ce jour, nous attendons à ce que la plupart d'entre eux atteignent les objectifs de réduction qui leur ont été fixés pour les deux dernières années de l'Examen des programmes.

2.4 Nous avons constaté que l'engagement des ministères et le leadership des ministères avaient contribué manifestement à imprimer une direction aux programmes de réduction et à leur donner de l'élan. Des facteurs tels que l'envergure des réductions, la préparation au changement et le temps accordé pour planifier ont eu une incidence sur la planification stratégique des réductions dans les ministères. Dans l'ensemble, les réductions ont été appliquées de façon rigoureuse et les employés ont été bien informés, tant avant que pendant le processus de réduction.

2.5 Bien que la plupart des objectifs de réduction aient été atteints et que nous ayons noté une amélioration en ce qui concerne l'observation des politiques de réduction des effectifs depuis la parution de notre chapitre dans le Rapport de 1992, intitulé « Paiements versés aux employés en vertu de la Politique sur le réaménagement des effectifs », nous avons constaté que certains ministères avaient pris des mesures discutables. La nécessité de mesures d'encouragement n'était pas toujours bien documentée, et certains ministères avaient tendance à demander des volontaires avant de désigner les postes qui étaient excédentaires. D'après les meilleures pratiques reconnues, une organisation devrait effectuer une analyse approfondie des coûts et des avantages des solutions de rechange, axer les mesures d'encouragement sur les secteurs qui en ont le plus besoin et déterminer la mesure dans laquelle il est nécessaire de demander des volontaires.

2.6 Les ministères se sont efforcés principalement d'atteindre leurs objectifs de réduction en temps voulu, en se souciant moins de la gestion des coûts. Divers facteurs ont contribué à cette absence générale de préoccupation des coûts dans les ministères : ces derniers ne disposaient pas, au début, des renseignements nécessaires sur les finances et les ressources humaines; ils n'avaient pas à financer entièrement les mesures d'encouragement au départ qu'ils appliquaient; la structure établie par le Secrétaire du Conseil du Trésor pour rendre compte des coûts des réductions des effectifs dans les ministères n'était pas claire.

2.7 Tout au long de la période des réductions des effectifs, les ministères ont fait preuve de compassion et de sensibilité envers les employés qui quittaient la fonction publique. En général, ils n'ont pas accordé autant d'attention aux employés qui demeurent en poste et à leurs préoccupations au sujet de la perte de collègues expérimentés et qualifiés, de la charge de travail de chaque employé et de l'orientation future du ministère. Alors qu'ils entreprennent maintenant une période de transition, les ministères devront non seulement rajuster leurs structures et leurs activités organisationnelles, mais aussi veiller à ce qu'ils puissent compter sur les effectifs dont ils auront besoin pour exercer leurs fonctions dans les années à venir.

Les réductions des dépenses et des effectifs au sein de la fonction publique



Chapitre 1 – Points saillants

1.1 Voici maintenant plus de dix ans que la fonction publique et les fonctionnaires sont touchés par des réductions des dépenses et des effectifs. En 1995, le gouvernement a lancé l'Examen des programmes, dont l'objectif était de repenser et de restructurer les programmes gouvernementaux en fonction des restrictions financières.

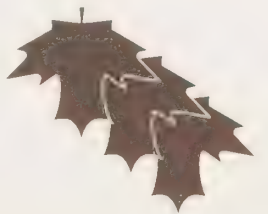
1.2 Afin de mieux gérer les réductions des dépenses et des effectifs, les organismes centraux ont cessé d'imposer, de réglementer et de donner des instructions au profit d'une approche consistant à donner l'orientation à suivre et à fournir de l'aide et des conseils aux ministères. Par exemple, au lieu d'adopter une approche « unique », le Secrétaire du Conseil du Trésor a proposé un cadre de gestion et de responsabilisation aux ministères et a permis que les programmes d'encouragement au départ tiennent compte du contexte et du milieu opérationnel propres à chaque ministère.

1.3 L'Examen des programmes a été un succès à de nombreux égards. Le déficit a été réduit et les frais de personnel ont baissé pour la première fois en plus de dix ans. En dépit d'un climat difficile, les réductions ont été mises en oeuvre sans arrêts de travail importants; en outre, les mesures financières d'encouragement au départ ont permis de minimiser le recours aux mises en disponibilité.

1.4 Toutefois, le coût des réductions des effectifs a été élevé sur le plan tant financier qu'humain. Par exemple, entre 1992 et 1997, le gouvernement a versé des indemnités à quelque 46 000 fonctionnaires, militaires et membres de la Gendarmerie royale du Canada qui ont quitté leur emploi ou pris leur retraite. Par ailleurs, les réductions des effectifs ont accru l'importance d'un certain nombre de questions touchant les ressources humaines, comme la nécessité de rassembler et de renouveler la fonction publique, et la nécessité de moderniser et de simplifier les systèmes de ressources humaines. De nombreuses études et nos propres travaux de vérification montrent que la fonction publique est une institution qui est soumise à de fortes pressions, et indiquent que des mesures vigoureuses doivent être prises maintenant.

1.5 Des améliorations importantes ont été apportées au cadre de gestion mis en place par les organismes centraux. Néanmoins, il faut redoubler d'effort pour améliorer la gestion des réductions des effectifs — par exemple, dans les groupes professionnels essentiels au sein desquels des employés peuvent être excédentaires dans certains ministères et demandés dans d'autres.

1.6 Il faut renforcer la reddition de comptes au Parlement sur les réductions des dépenses et des effectifs, et les coûts qui s'y rattachent. Il y a lieu également de clarifier le rôle, les responsabilités et l'obligation de rendre compte des organismes centraux et des ministères pour ce qui est de la gestion des réductions des effectifs.



Avant-propos

Je suis heureux de vous présenter le volume d'avril de mon rapport de 1998. Cet avant-propos est suivi des Points saillants des neuf chapitres, qui sont publiés séparément :

1. Les réductions des dépenses et des effectifs au sein de la fonction publique
2. Les réductions des dépenses et des effectifs dans certains ministères
3. Défense nationale — Equiper et moderniser les Forces canadiennes
4. Défense nationale — Grands projets d'acquisition de biens d'équipement
5. Revenu Canada, ministère des Finances et ministère de la Justice — L'administration interministérielle du régime d'impôt sur le revenu
6. Le vieillissement de la population et l'information destinée au Parlement : pour comprendre les choix
7. Le projet de construction d'un complexe de laboratoires fédéraux de santé humaine et animale
8. Ministère des Finances — Mesurer l'efficacité et en rendre compte
9. La présentation des résultats financiers du gouvernement : l'importance de respecter des normes comptables objectives

Les réductions des dépenses dans l'ensemble du gouvernement, au cours des dernières années, font que de nombreux ministères ont moins de ressources et moins de latitude pour faire face aux nouvelles priorités. Le Rapport indique qu'il est plus difficile pour les ministères de choisir parmi les programmes et les projets qu'ils financent, les pratiques et les processus qu'ils suivent, les services qu'ils assurent et les façons de les assurer. Dans ce contexte, il importe plus que jamais de se fonder sur de l'information fiable pour choisir les dépenses qui seront engagées. Les décideurs doivent analyser les coûts, les avantages et les risques associés aux diverses options avant d'engager des fonds limités dans de gros achats. Il faut établir des normes de rendement claires et exercer une surveillance continue pour assurer le respect constant des normes. Divers chapitres du Rapport portent sur plusieurs grands projets gouvernementaux et présentent une analyse de ces aspects.

D'autres pays, avant le Canada, ont entrepris de rationaliser leurs administrations, et leur expérience fournit des leçons utiles susceptibles d'être adaptées ici. Nous en faisons état dans quelques chapitres.

Enfin, certains chapitres traitent de la nécessité pour le gouvernement de fournir de l'information financière solide et objective sur laquelle les Canadiens, et les partenaires du Canada, peuvent compter quand ils prennent des décisions dont les répercussions se feront sentir pendant des décennies.

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Avant-propos et Points saillants

Avril 1998

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**Report of the
Auditor General
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Expenditure and Work Force Reductions
in the Public Service

Chapter 2
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April 1998

This April 1998 Report comprises 9 chapters and a Foreword and Main Points. In order to better meet clients' needs, the Report is available in a variety of formats. If you wish to obtain another format or other material, the Table of Contents and the order form are found at the end of this chapter.

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Cat. No. FA1-1998/1-2E

ISBN 0-662-26791-5

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Chapter 1

Expenditure and Work Force
Reductions in the Public Service

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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Expenditure and Work Force Reductions in the Public Service

Main Points

1.1 Expenditure and work force reductions have affected the public service and public servants for more than a decade. In 1995, the government launched Program Review, an initiative aimed at rethinking and realigning government programs in light of fiscal restraints.

1.2 To better manage expenditure and work force reductions, central agencies moved from imposing, directing and prescribing to providing leadership, guidance and support to departments. For example, instead of adopting the "one size fits all" approach, Treasury Board Secretariat proposed a management and accountability framework to departments and allowed incentive programs to take into account the differences in their context and operational environment.

1.3 Program Review was a success from many perspectives. The deficit has been reduced and personnel costs have decreased for the first time in more than a decade. In spite of a difficult climate, reductions were implemented without major work disruptions; and financial departure incentives have been effective in minimizing layoffs.

1.4 The cost of achieving work force reductions was high, however, not only in dollar terms but in human terms as well. For example, between 1992 and 1997 the government paid incentives to some 46,000 public servants, military and RCMP members to leave or retire. Furthermore, work force reductions have amplified a number of human resource issues, such as the need for rejuvenation and renewal and the need to modernize and simplify human resource systems. Many studies and our own audit work indicate that the public service is an institution under significant stress and that strong actions are now required.

1.5 Significant improvements were made in the management framework put in place by central agencies. Nonetheless, more efforts are needed to improve the management of work force reductions — for example, in critical occupational groups where there might be surpluses in some departments but shortages in others.

1.6 There is a need to improve accountability to Parliament for expenditure and work force reductions, and for the related costs. Roles, responsibilities and accountabilities of central agencies and departments in the management of work force reductions also need to be clarified.

Introduction

Deficits, Fiscal Restraints and Work Force Adjustments

1.7 From the end of the Second World War to the early 1970s, the Canadian economy grew considerably. The growth in the range of social and economic activities of the government significantly increased the size of the public service. One exception was the period from 1958 to 1963, when Canada faced a recession that resulted in sustained deficits and a number of restraint measures, such as freezes on public service hiring.

1.8 In the 1970s, increases in government spending and events such as rising oil prices and interest rates, the resulting slowdown of the economy, the indexation of social programs and the de-indexation of tax made deficits a continuing feature of federal budgets. Recurrent deficits led to a series of restraint measures, including:

- a decision in 1985 to reduce the size of the public service by 15,000 person-years over five years (person-year was the indicator the government used at the time to measure the “consumption” of labour);
- decisions starting in 1991 to reduce the size of the Department of National Defence from 84,000 to 60,000 military members, and a decision in 1994 to reduce its civilian work force from 36,000 to 20,000, both reductions to be achieved by March 1999;
- the freezing of salaries and the suspension of collective bargaining for six years starting in 1991;
- the transfer of the administration of transportation facilities, such as airports, to local authorities starting in 1992;

- a comprehensive reorganization in June and November 1993 that reduced the number of departments from 35 to 23, along with a requirement to significantly reduce administrative costs.

Exhibit 1.1 presents key restraint measures and others introduced over some 30 years that impacted on the size of the public service or otherwise affected public servants.

1.9 To minimize layoffs by redeploying public servants touched by restraint measures, in the 1960s the government approved the Work Force Adjustment Policy. In 1985, it began to use financial incentives to achieve work force reductions by enticing public servants to leave the public service voluntarily. The Policy (renamed the Work Force Adjustment Directive in 1991) and related incentives were modified periodically. One significant modification in 1991 added a clause guaranteeing a “reasonable job offer” to surplus public servants before they could be laid off. “Reasonable job offer” was defined in terms of salary level as well as distance from the employee’s work location. Public service unions viewed the “reasonable job offer” guarantee as tantamount to job security.

1.10 To deal with situations that it believed could not be accommodated under the Work Force Adjustment Directive, the government introduced other directives and departure incentive programs over the years. In 1992, for example, the first of several Force Reduction Programs was approved for the Department of National Defence. It allowed for the cash payment of special leave to non-commissioned members in overstuffed military occupational groups who volunteered to leave. Also in 1992, the government approved the Executive Employment Transition Policy because it was felt that executives could not be guaranteed a “reasonable job offer”. In 1994, the Civilian Reduction Program was approved to permit the Department of

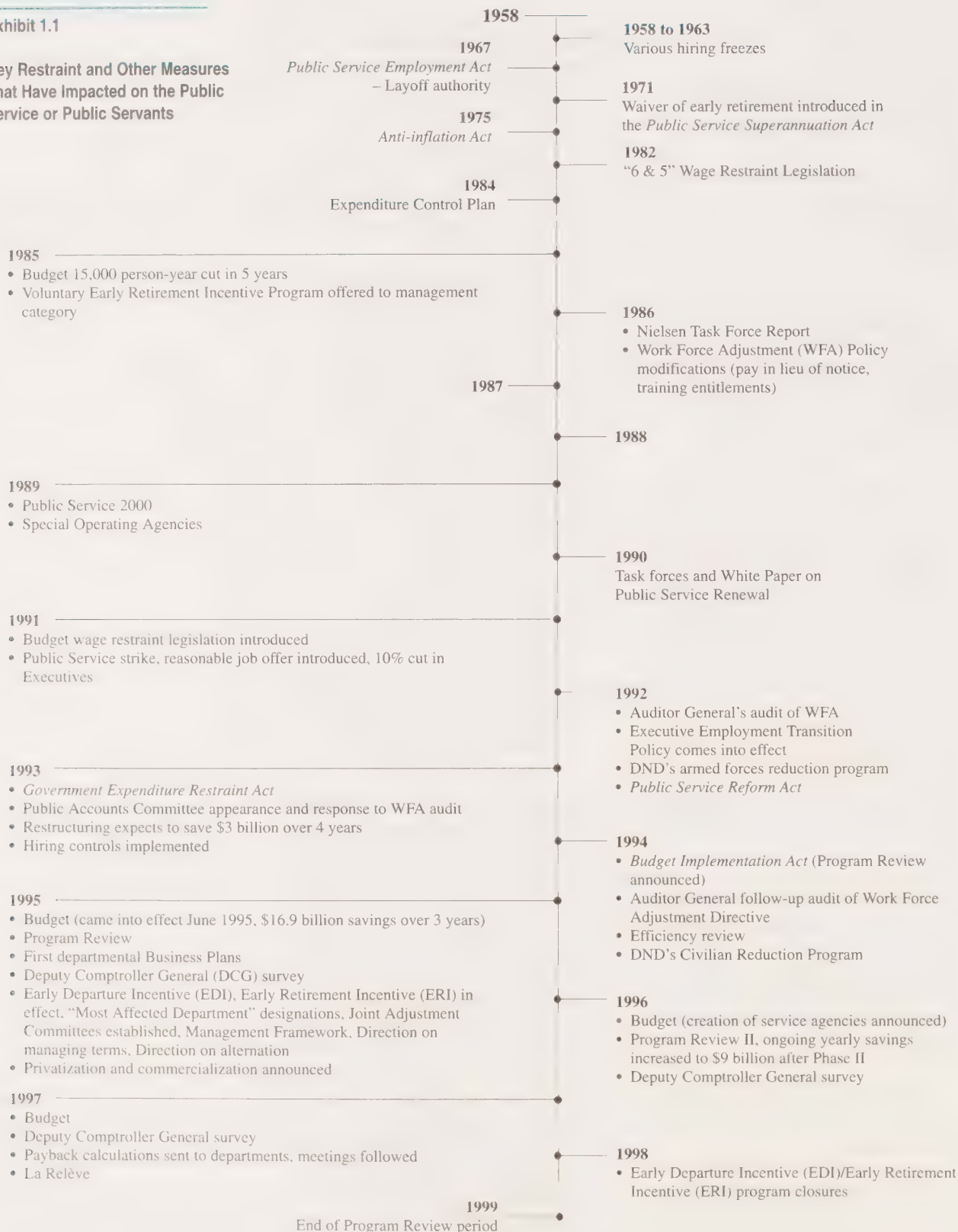
In the 1970s, recurrent deficits led to a series of restraint measures.

In 1985, the government began to use financial incentives to achieve work force reductions.

Expenditure and Work Force Reductions in the Public Service

Exhibit 1.1

Key Restraint and Other Measures That Have Impacted on the Public Service or Public Servants



Source: Treasury Board Secretariat and OAG

National Defence to deal with the reduction of its civilian work force due notably to base closures.

1.11 In spite of all the measures announced by governments, in the '80s and early '90s expenditures continued to increase. This led to deficits reaching alarming proportions. A consensus was emerging that the fiscal situation called for different and more drastic measures.

On the Verge of a Crisis: Program Review and Other Reviews

1.12 Program Review focussed on realigning programs in light of fiscal constraints. In 1994, a number of factors threatened the deficit target of three percent of GDP that the government had committed itself to achieve by 1996–97. The unstable fiscal situation meant that initiatives under way took on greater importance. Under the umbrella of a renewal initiative called “Getting Government Right”, the government launched a number of reviews. One of these was Program Review, which consisted of the scrutiny and review of “program spending” (non-statutory spending representing some \$50 billion of government expenditures out of a total of some \$160 billion) and a re-examination of the federal government’s role and responsibilities in delivering those programs.

1.13 Program Review asked ministers and their officials to submit programs to a test of six primary questions:

- Does the program or activity continue to serve a public interest? (public interest test)
- Is there a legitimate and necessary role for the government in this program area or activity? (role of government test)
- Is the current role of the federal government in this program a candidate for realignment with the provinces? (federalism test)

- What activities or programs should or could be transferred in whole or in part to the private or the “voluntary” sector?(partnership test)

- If the program or activity continues, how could its efficiency be improved? (efficiency test)

- Is the resultant package of programs and activities affordable within fiscal restraint and, if not, what programs or activities should be abandoned? (affordability test)

1.14 To assist ministers and departments, programs were assigned “notional” centrally established fiscal targets for expenditure reduction over three years. These were targets that the Department of Finance, assisted by the Treasury Board Secretariat, estimated would have to be met for the government to reach its overall fiscal objective. Central ministerial and deputy ministerial committees were set up and tasked with the responsibility of reviewing plans prepared by individual ministers and their officials. A Secretariat was created in the Privy Council Office to support the work of the committees and advise departments on their plans. Recommendations and decisions on programs that had been reviewed were reflected in the 1995 Budget.

1.15 The Minister of Finance announced in February 1995 that Program Review would result in some \$17 billion in expenditure reductions over three years. This would contribute to a net reduction of \$9.8 billion in federal departmental spending levels between 1994–95 and 1997–98. Many departments saw their spending levels cut by 20 percent or more. It was also announced that Program Review and other reviews, such as policy reviews, would result in structural changes to the public service — for example, the commercialization of air navigation services, the privatization of the Canada Communication Group, the creation of new agencies like the Canadian Food Inspection Agency and others, and the

In 1994, a number of factors threatened the deficit target of three percent of GDP that the government had committed itself to achieve by 1996–97.

The Minister of Finance announced in February 1995 that Program Review would result in some \$17 billion in expenditure reductions over three years.

To minimize involuntary layoffs, the government approved two special departure incentive programs.

abolition or restructuring of some 120 government agencies. It was estimated that by 1997–98 such measures would reduce the public sector work force, including National Defence and the RCMP, by as much as 45,000.

1.16 Special incentive programs introduced. Among other measures to facilitate departments' implementation of Program Review and other expenditure reduction decisions, and to minimize involuntary layoffs, the government approved for parts of its work force two special departure incentive programs for a three-year period to end in 1998: the Early Retirement Incentive program and the Early Departure Incentive program. The Early Departure Incentive was offered in exchange for a three-year suspension of the "reasonable job offer" in the "most affected departments". To be declared "most affected" by Treasury Board, departments had to be unable to meet their work force reductions under the Work Force Adjustment Directive and other existing management measures.

1.17 In February 1995, the government stated that the "cost of the cash-based early departure incentives" would be about \$1 billion. Appendix A summarizes key departure incentive programs used over the years to entice surplus military members, RCMP members or public servants to voluntarily retire or leave.

1.18 Program Review Phase II. By September 1995 there was a general perception that still more could be achieved. Given this perception, and the need to meet further fiscal targets, the government launched Program Review Phase II. However, departments were informed that decisions reached in the first phase of Program Review would not, as a rule, be revisited.

1.19 In the 1996 Budget, the Minister of Finance estimated that Program Review II would result in further expenditure

reductions of some \$2 billion by 1998–99. Significant structural changes would also occur through the devolution, privatization or commercialization of government activities, such as the devolution of harbour administration to local authorities. It was estimated that possibly 10,000 jobs would be eliminated, in addition to the previously estimated 45,000 to be affected under Program Review I.

Previous Audit Work Performed by the Office

1.20 In November 1992 this Office reported to Parliament the results of an audit of payments made to employees under the Work Force Adjustment Policy (later Directive) from 1986 to December 1991, before the inclusion of the "reasonable job offer" guarantee. We reported that while some departments had managed to reduce their work force cost-effectively, others had not managed payments to employees with the same due regard to cost effectiveness. We also noted that payments had been used for reasons other than those specified in the Policy.

1.21 The Office concluded that central funding, inadequate information and ineffective controls in central agencies and departments had led to a gradual deterioration in the management of financial incentives. Many public servants perceived such incentives as normal entitlements upon retirement or upon leaving the public service. In our 1994 follow-up, we reported that a number of initiatives aimed at addressing those issues were at various stages of implementation.

Focus of the Audit

1.22 The objectives of our audit were:

- to determine the extent to which announced targets for expenditure reduction or, where specified, work force reduction have been or are likely to be achieved;

- to identify the cost of work force reductions and determine the extent to which the initiatives resulted in savings;
- to assess the extent to which departure incentive programs were managed in accordance with relevant policies, directives or guidelines; and
- to identify lessons learned for possible application in the future.

1.23 This chapter reviews the evolution of expenditure and work force reductions over the years and provides a global assessment of the results, with an emphasis on the management of expenditure and work force reductions announced since 1995, pursuant to Program Review and related initiatives. It focusses on central agencies (Department of Finance, the Treasury Board Secretariat and the Privy Council Office) and the extent to which they provided clear direction to departments or put in place a management and accountability framework for cost-effective implementation of reductions and for achievement of overall results. Chapter 2 examines the implementation of expenditure and work force reductions in a number of departments. We did not examine the merits of the specific decisions resulting from Program Review; also excluded was any evaluation of the impact of work force reductions on individuals laid off. Further details on the audit objectives, scope, criteria and approach are presented in **About the Audit** at the end of Chapter 2.

Observations

Different Approaches Yield Different Results

1.24 Over the last three decades, governments have used different approaches to wrestle the deficit and reduce the size of the public service, with varying degrees of success.

1.25 Historically, the response to deficits was simple: let's reduce, cap or limit the growth of expenditures until revenues catch up. The underlying assumption was that deficits were an aberration that would not last. Staffing or salary freezes and across-the-board expenditures and work force reductions are examples of this kind of response. Our review of best downsizing practices revealed that such approaches generally do not result in long-term benefits, as shown by attempts in the late 1970s and mid-1980s to reduce the public service, and by efforts to reduce the size of the executive cadre. Over time, because such reductions are not anchored to changes in structures and work processes or to decisions to abandon or transfer activities, staff levels are likely to go back to former levels, if not higher.

1.26 The second approach used by governments to tackle deficits and reduce expenditures over the years has been "rationalization". Reorganizing, streamlining, re-engineering or implementing "total quality" concepts are examples. Public Service 2000, the 1993 restructuring and reorganization of the government, and the *Blueprint for Renewing Government Services Using Information Technology* of 1994 are specific "rationalization" measures taken by the federal government. The underlying assumption is that efficiency gains will help to improve or redress the fiscal situation. What the experience of the public service shows, however, is that rationalization takes time to produce efficiency gains, that efficiency gains may not materialize if projects fail, or that the gains may not be as high as anticipated. Furthermore, rationalization efforts often require additional resources at the front end because operations must continue while the desired transformation is being planned, developed and tested. In the meantime, moreover, the fiscal situation may continue to deteriorate, as federal deficits did in the early nineties. If achieved, however, efficiency gains

This chapter reviews the evolution of expenditure and work force reductions over the years and provides a global assessment of the results.

From 1985 to 1995, attempts at reducing personnel costs have not succeeded in producing a downward trend in those expenditures.

resulting from rationalization efforts can be long-lasting. In such instances, downsizing is likely to be more permanent although a large number of low-paid jobs may be replaced by higher-paid but fewer jobs.

1.27 The third approach used by governments has been to realign or “rethink” programs with a view to making government more economical, effective and efficient (as the 1984 Nielsen Task Force undertook to do). The underlying assumption is that some activities need to be terminated or transferred and some assets sold in order to protect others judged more important or valuable. The issue is the role of the government, and one of the deciding factors is the capacity to pay. Examples are the devolution of airports and harbours and the privatization of Crown corporations. In such instances, although other issues may arise — the issue of accountability, for example — work force reductions are more likely to be permanent since the government no longer performs the function.

1.28 The importance of selecting the right target. Over the last two decades, attempts by government to reduce expenditures and the size of the public service have focussed on person-years, positions, indeterminate employees, reporting levels or salary expenditures. Exhibit 1.2 shows that from 1985 to 1995, attempts at reducing personnel costs — such as salary freezes or the 15,000 person-year reduction announced in 1985 — have not succeeded in producing a downward trend in those expenditures; year after year, personnel costs continued to increase, although at a lower rate. Some of the reasons for the slow but continued yearly growth include the introduction of new programs, resulting in hiring that offset work force reductions made in other programs; the increased professionalization of the public service; and cash payments made to employees under various incentive programs.

1.29 Such results demonstrate the importance of choosing the right target and of deciding what, in the end, should be measured. For example, because the

Exhibit 1.2

Variations in Personnel Costs for the Government of Canada from March 1985 to March 1997



Source: Public Accounts of Canada

focus from 1985 to 1991 was on person-year reductions, there was an increase in forms of employment not subject to person-year controls — such as temporary assistance — even though this was not necessarily cost-effective. For lasting results, the target selected must be sufficiently encompassing to permit managers to make cost-effective choices, such as the most appropriate mix of resources required, and it must be driven by permanent changes in structures, work processes or the nature of programs or activities.

Program Review: Significantly Different from Previous Initiatives

1.30 Our audit work in departments, our review of documentation and our interviews with current or former senior officials reveal that there were significant differences between Program Review and previous attempts to reduce expenditures or the work force (see Exhibit 1.3). Some of the most significant factors that distinguished Program Review include the following:

- From a central agency perspective, Program Review focussed exclusively on reducing expenditures, not staff levels. It was not the government's objective to reduce the public sector by some 55,000 employees. That number illustrated the magnitude of the impact of the expenditure reduction targets.
- There was a strong resolve at the political level to achieve the deficit target of three percent of GDP and the required expenditure reductions, because there was a broad recognition of the need for urgent action. The credibility of the government in relation to its commitment was at stake.
- Expenditure reductions could be strategic and selective because there were clear, logical and easy-to-understand criteria for the review and prioritization of programs and for making decisions about expenditure reductions.

- Ministers and departmental officials were key players. They were given the responsibility and the flexibility to propose specific areas where revenues could be generated or where expenditures could be reduced in light of overall fiscal targets.

- Ministers and their officials were made more aware of the need to rethink and redesign programs and services and to be innovative because at the outset, “notional” targets and the three-year horizon gave a better appreciation of the magnitude of the total effort required of them.

- Departments were given three years to implement Program Review I and II decisions, with the assurance of some stability in funding. As a general rule, decisions flowing from Program Review I were not revisited.

1.31 A number of areas nevertheless presented challenges or difficulties. The most significant included the following:

- The time frame between the launching of Program Review in May 1994 and the deadline for departments to submit plans (August 1994) was very short. Partly as a result, the “affordability test” was the determining factor driving proposals and eventually decisions. There was not much time for analyzing in detail the potential impact of the cuts proposed.
- Differences in planning assumptions and in the information available at the central agency level and that available in some departments led to sometimes lengthy discussions about the numbers to be used as a base for making expenditure reductions and for setting fiscal targets.
- The responsibility for raising horizontal issues was left mostly with departments. A number of horizontal issues were raised, and some — like the consolidation of responsibilities for food inspection — were resolved. However, other issues were not raised or could not be resolved, like the presence of many

From a central agency perspective, Program Review focussed exclusively on reducing expenditures, not staff levels.

government departments in international affairs and in our embassies instead of a more centralized approach, and the roles and responsibilities of central agencies in the governance of the public service and in human resource management.

Exhibit 1.4 illustrates some of the challenges or difficulties associated with Program Review.

The Management and Accountability Framework at the Centre: Significant Improvements

1.32 The changing role of central agencies. Another factor in the difference between previous attempts to reduce expenditures and Program Review has

Exhibit 1.3

Some Key Differences between Program Review and Other Expenditure Reduction Initiatives

- **A strong political resolve.** There was an atmosphere of crisis and, because the credibility of the government was clearly at stake, there was a strong resolve at the political level to achieve the three percent of GDP deficit target and the required expenditure reductions. Global fiscal parameters were clearly understood; the need to reduce the deficit provided focus.
- **A strategic perspective.** The six questions provided a clear, logical and easy-to-understand framework for the review of programs, their prioritization and strategic and selective decision making about expenditure reductions, instead of across-the-board cuts. Guided by the clear objective and the conceptual framework, central agencies and, within central agencies, branches or divisions were able to work more closely together.
- **Clear goal and vision prompting innovation.** Expenditure reduction decisions were expressed in terms of overall expenditures, or "base reference levels", rather than focussing on reducing positions, person-years or payroll costs. Expenditure reduction targets and the three-year horizon provided by the Department of Finance gave a clear idea of the magnitude of the total effort required by ministers and their officials. This prompted them to rethink, to redesign programs and services and to be more innovative.
- **The direct involvement of ministers.** Program Review was not a centrally driven process. Collectively as well as individually, ministers were directly involved and Program Review decisions were approved by Cabinet or, in a number of cases, the Prime Minister.
- **A special management structure was created.** A special structure was established to manage the process. Two committees were formed: the Co-ordinating Group of Ministers (CGM) chaired by the Minister of Public Service Renewal, and the Steering Committee of Deputy Ministers (SCDM) chaired by the Clerk of the Privy Council and Head of the Public Service. A Secretariat was created to support the two committees. The committees reviewed the plans proposed by departments and provided guidance and advice. The committees sent a clear message, at the outset, that the fiscal targets had to be met and that if plans came short of that, departments would have to go back and revisit. This was seen as a test of the resolve of the government; people at the centre realized that giving in would have jeopardized Program Review. Some of the discussions with departments nevertheless lasted until the presentation of the 1995 Budget.
- **The process respected differences between departments.** Individual ministers and departmental officials were given the responsibility to propose where, specifically, in their portfolio, programs and services expenditure reductions could occur within the boundaries set by the fiscal targets. Departmental officials had the flexibility to decide where revenues could be generated or how expenditure reductions would be implemented.
- **Effective communications.** Within government the process was open and transparent, sending a message to departmental officials that the new approach was different and that it was not only about expenditure reductions; there were no "surprises".
- **A reasonable time frame for implementation.** Departments were given three years for implementing Program Review I and Program Review II decisions, with assurance of stability in funding during this period.
- **Decisions were not revisited.** Decisions flowing from Program Review I were firm and, as a rule, they were not revisited.

been the changing role of central agencies. For example, central agencies moved from imposing, directing and prescribing to providing leadership, guidance and support to departments, which were made responsible for deciding how and where expenditure reduction would be implemented. Central agencies managed the Program Review process and, within the boundaries of notional targets, they provided peer review guidance and advice to departments. Furthermore, instead of

adopting the “one size fits all” approach of the past, Treasury Board allowed incentive programs to take into account the differences in the context and operational environment of departments. If they felt the need, for example, departments could ask to be declared a “most affected department”. In March 1995, 11 departments and agencies were designated “most affected departments”. As of March 1997, there were 17 such departments and agencies.

Another factor in the difference between previous attempts to reduce expenditures and Program Review has been the changing role of central agencies.

- **A short time frame to submit proposals.** The time frame between the launch of Program Review (May 1994) and the deadline for departments to submit their proposals for expenditure reductions (August 1994) was short. Thus, there was not much time for analyzing in detail the impact of what was proposed. Not all departments met the deadline. The short time frame resulted in the final test, the “affordability test”, being the determining factor that drove proposals and eventually decisions.
- **Difficulties of setting fiscal targets at the portfolio level.** Fiscal targets for ministerial portfolios were based on perceptions and the experience of central agency personnel; there was no scientific basis for them. As a result, some could be challenged or negotiated. Furthermore, significant differences in information available at the central agency level compared with that available in departments led to at times lengthy and arduous discussions about the numbers that were to be used as a base for making expenditure reductions.
- **Departmental performance varied.** Departments that had launched their own rethinking initiative prior to Program Review were generally better positioned to review their programs within a strategic framework than those departments restructured in June or November 1993. There were also differences in the way that departments applied the six test questions, and the results were uneven, depending on several variables such as the degree of commitment and involvement of departmental officials. Even if departments were asked to look at programs and activities for a more strategic focus and improved co-ordination and integration of programs and activities within their portfolio, such strategic frameworks were generally not developed. There were no specific criteria or predetermined performance indicators that could be used to objectively evaluate the performance of departments.
- **Certain issues were not raised or not resolved.** The responsibility for raising horizontal issues was left mostly with departments, the “centre” intervening only at the request of ministers. Although a number of horizontal issues were raised, and some resolved – such as the consolidation of responsibilities for food inspection – other issues were not identified or could not be resolved, such as the presence of many government departments in international affairs and in embassies, instead of a more centralized approach. Certain functions or activities were not examined, such as the roles and responsibilities of central agencies in relation to governance or to human resource management.
- **Program Review II.** Although decisions stemming from Program Review I were not revisited, the announcement of Program Review II soon after so much effort had been devoted to meet the requirements of Program Review I had some negative effect. More expenditure reductions were required and a 3.5 percent across-the-board cut was imposed on departments and agencies.
- **Renewal initiatives.** While renewal initiatives such as La Relève are seen by central agencies as an opportunity to tackle persistent and emerging human resource issues, they are received with cynicism by officials in some departments still struggling with downsizing issues – partly because human resource issues, such as the need for renewal and rejuvenation, have been made worse by the implementation of Program Review decisions. Furthermore many departments had not integrated such issues in their expenditure reduction plans, or made allowance for addressing them.

Exhibit 1.4

Some of the Challenges or Difficulties Associated with Program Review

The Treasury Board Secretariat developed an accountability framework for the management of work force adjustments.

One of the key features of the management and accountability framework was the cost-effectiveness test known as “payback”

1.33 A number of tools and mechanisms were put in place. In response to our 1992 Report chapter, which was critical of the management and administrative frameworks at both the central agency and the departmental levels, the Treasury Board Secretariat developed an accountability framework for the management of work force adjustments as well as a number of measures and tools. The tools include, for example, a manager’s guide and an audit guide on work force adjustments. Periodically, guidelines and clarification were issued dealing with areas such as post-employment or contracting with former public servants.

1.34 Committees were created, including union-management committees. A number of committees were created such as the National Joint Adjustment Steering Committee; the Committee of Departmental Work Force Adjustment Co-ordinators; and the Joint Adjustment Committees composed of management and union representatives. The purpose was to ensure a better management of work force reductions across the public service. Our interviews and a review of their activities revealed that Joint Adjustment Committees, especially outside the National Capital Region, have greatly facilitated the placement or relocation of public servants. For a number of reasons, this mechanism has not worked as well in the National Capital Region. We noted that Joint Adjustment Committees outside the National Capital Region have facilitated the application across departments of the alternation process (also known as “swapping”). This process permits public servants who want to retire or leave the public service to switch jobs, subject to management approval, with employees who have been declared “affected” but wish to remain in the public service. Since 1995, some 2,600 “swappings” have been reported by Joint Adjustment Committees. People we interviewed who have been associated with the work of these

committees said that it has improved union-management relationships significantly; in their view, this concept could be used to address other human resource issues, such as training and mobility.

1.35 A management and accountability framework was proposed to departments. In December 1995, the Treasury Board Secretariat proposed a management and accountability framework to assist departments in the prudent and cost-effective management of the Early Retirement, Early Departure and other incentive programs and related expenditures. Included in this framework was a requirement for an audit of the administration of the program in midcourse and the provision of accurate, accessible, timely and reliable information, as well as a monitoring framework aimed at ensuring that incentive programs were contributing to departments’ progress toward targets set out in their Business Plans. Other objectives of the framework were to ensure probity and compliance and the monitoring of equity issues that might arise from disproportionate job cuts across occupational or demographic groups. Although some Treasury Board Secretariat officials had suggested that formal agreements with departments would ensure greater accountability, this suggestion was not accepted. It was perceived to be inconsistent with the approach used for Program Review, which was to make departments responsible and accountable for deciding on and implementing expenditure reductions as they considered appropriate in their context.

1.36 A test of cost effectiveness: “payback”. One of the key features of the management and accountability framework was the cost-effectiveness test known as “payback”, which is somewhat akin to the concept of “return on investment”. The Treasury Board Secretariat wanted to ensure by

introducing the payback concept that departure incentives would result in downward trends in salary, wages and benefits and that the costs associated with incentives would not be higher than the overall reduction in salary, wages and benefits. As initially defined by Treasury Board Secretariat, payback is the relationship between the costs associated with departure incentive programs and the reduction in salary wages and benefits during Program Review. The costs are to be measured from April 1995 to September 1998 and the reduction generated is to be measured from April 1995 to March 1999.

1.37 The cost portion of the equation used to calculate payback is defined as the incremental costs associated with departure incentive programs but excluding payments for severance and vacation pay. It also includes the cost of the pension waiver for the Early Retirement Incentive program. The other portion of the equation is determined by the reduction in salary, wages and benefits after four years. In January 1998, the Treasury Board Secretariat estimated that incremental costs associated with departure incentive programs (\$3.2 billion) will exceed the net reduction in salary, wages and benefits (\$2.5 billion) at the end of Program Review in March 1999. This is partly due to the lower than expected take-up rate for the Early Departure Incentive and the higher than expected take-up rate for the more expensive Early Retirement Incentive. Treasury Board Secretariat officials had initially estimated that some 4,000 individuals would opt for early retirement; as of March 1997 the number was about 8,000. Some of the reasons for this variation include the introduction of the alternation process (paragraph 1.34), the suspension, for three years, of the 15-week separation benefit as of 15 July 1995 and additional reductions under Program Review II. While officials had estimated that between 13,000 and 15,000

individuals would opt for the Early Departure Incentive where offered, only some 7,500 surplus employees had done so as of March 1997. As part of its monitoring, Treasury Board Secretariat calculated payback for departments and agencies whose departure cost estimates had changed significantly from earlier projections. In calculating payback, the Secretariat refined its initial definition of expenditure reductions to include changes in the employer's contribution to employee benefit plans. This has resulted in a series of discussions with departments about the methodology used and the usefulness of payback as an indicator.

1.38 We believe that in its concept, payback is not only sound but also essential; we acknowledge the efforts of the Treasury Board Secretariat to provide departments with such a tool. The introduction of this concept was consistent with best practices and with comments we made in our 1992 Report. At that time, we noted that one of the reasons why payments to employees under the Work Force Adjustment Policy were not managed cost-effectively was that managers had no information about the total cost to the taxpayer of such incentives. Individual decisions to grant the incentives simply did not take costs into consideration. In our opinion, a cost effectiveness indicator or measure such as payback can, when effectively designed, provide additional information to a decision to grant departure incentives, while providing managers with strong motivation to give more attention to the need for balancing costs and savings.

1.39 Nonetheless, to improve payback as a monitoring tool and as a measure of cost effectiveness, in our opinion a number of issues in its design and application need to be addressed to make it more relevant and more useful:

- Payback is essentially a financial indicator and is very limited in its ability to provide an assessment of the overall quality of the management of incentive

To improve payback as a monitoring tool, a number of issues need to be addressed.

The quality of information has improved, but the reconciliation and consolidation of information need to be improved.

programs; other factors or indicators must also be taken into account. In their own midterm reviews and in the course of our audit, departments raised concerns about the applicability of payback as a measure of cost effectiveness.

- Introducing payback at the same time as the incentive programs would have made managers more aware of the necessity to balance costs and savings. We noted that payback was formally introduced in December 1995, months after departments had approved incentives for a significant number of employees.

- To be held accountable for the prudent and cost-effective management of incentive programs, departments would have needed an understanding and acceptance of the objective, purpose and parameters of payback before it was formally introduced. Our examination of departmental midterm review reports indicates that the application and usefulness of payback were not always well understood.

- The relationship between the costs of incentive programs and the savings they directly generate needs to be clear. As currently calculated, payback makes no distinction between reductions in salary and wages generated by each of the departure incentive programs and those generated by natural attrition, the creation of alternative delivery mechanisms, and the transfer or privatization of activities. Nor is it clear whether the basis used to calculate reductions in salary wages and benefits should be the “net method” — the reduction in salary and wages between the end of Program Review and the beginning; or the “cumulative method”, in which reductions incurred in each year are cumulated until the end of the period; or the “global method” where reductions in salary, wages and benefits are considered in the context of reductions in overall expenditures. How one defines and calculates reduction in salary and wages can impact significantly on the way one

interprets the cost effectiveness of work force reductions during and after Program Review.

- In the calculation of payback, a mechanism is needed to recognize increases in salary and wages resulting from new program initiatives that, if not taken into consideration, may offset the reduction in salary and wages and result in a longer payback period than expected.

- Some significant incremental costs associated with, or arising from, work force reductions need to be factored in. For example, incremental severance paid to employees because severance entitlements are higher for employees whose service is terminated than for those who leave of their own volition should be included, because they can be significant (Appendix A). In our 1997 chapter, *Transport Canada — The Commercialization of the Air Navigation System*, we estimated that 28 percent or \$31.5 million of the total estimated \$112 million in severance costs were because severance was paid out at the layoff rate.

- If payback is to be calculated over a set period of time, as it is now, the impact of the timing of incentive payments on the ability to generate a reduction in salary wages and benefits within that period needs to be considered.

1.40 Information needs to be improved further. In response to our 1992 audit and our follow-up in 1994, the Treasury Board Secretariat and the Public Service Commission made efforts to improve central information systems so the administration of the various financial incentives could be monitored more effectively. The quality of information has improved, but we found in particular that the reconciliation and consolidation of departure incentive information — such as costs of incentives and numbers of recipients, originating from a variety of sources — need to be improved to provide

for more effective monitoring and improved accountability.

1.41 Some of the difficulties we have noted are structural. For example, the Department of Finance's responsibilities in the budgetary process and the Treasury Board's responsibilities for financial management apply to the public sector as a whole, which includes more than 90 entities (including military personnel and RCMP members). Treasury Board's responsibilities as the Employer apply only to the public service, which includes some 60 organizations (and excludes military personnel and RCMP members). In other words, some agencies or categories of personnel are included in one universe but not in the other. As a result, information on the costs of incentives that appears in the Public Accounts and the Financial Statements of the Government of Canada cannot be reconciled easily with information reported by Treasury Board on the number of incentive recipients and on public service work force reductions. Moreover, the universe of the Public Service Commission, the agency responsible for assisting departments with the placement or redeployment of surplus employees, is different yet again. Finally, information on the costs of downsizing that was initially contained in the Public Accounts as a Note to the Financial Statements was not included for 1996–97. It is thus difficult to obtain a comprehensive picture of expenditure and work force reductions and the associated costs in the public service and in the broader public sector. Appendix B presents a schematic view of the work that was required to reconcile and analyze information for the purpose of this audit.

1.42 There are other difficulties with the purpose, sources and timing of the information. For example, the Comptroller General obtains information on incentive recipients directly from departments, while the Human Resources branch of the Treasury Board Secretariat extracts

information on recipients from central information systems such as the pay system. For the seven departments we selected for a more detailed examination (see Chapter 2), the discrepancy between the information available in the department and the information available to the Treasury Board Secretariat from March 1995 to March 1997 was eight percent or more. No reconciliation of these numbers has been performed.

1.43 Little or no information available in Performance Reports of departments or central agencies. We reviewed a sample of departmental and central agency Performance Reports for the year ending 31 March 1997. We found that they provide Parliament with little or no information on the extent to which incentives have been used, their costs, and savings that resulted.

1.44 Consistent with the views expressed in our 1994 Report chapter, Information to Parliament, we believe that expenditure and work force reduction initiatives lend themselves to a special report that would provide information on costs, savings, staff affected and so on for the government as a whole, and for the public service.

1.45 We believe that overall, in spite of the shortcomings we have noted, the framework put in place by central agencies to assist departments in managing and administering work force reductions and departure incentive programs in a cost-effective way represents a significant improvement over the situation in 1992, when central agencies and departments had conducted relatively few audits, reviews or evaluations of the management of work force adjustments. Since 1995, some 50 audits or reviews have been carried out on behalf of the Treasury Board Secretariat or by departments, covering various aspects of expenditure and work force reductions, including the use of incentives. Treasury Board Secretariat officials have informed us that in their

It is difficult to obtain a comprehensive picture of work force reductions and the associated costs.

Expenditure and work force reduction initiatives lend themselves to a special report that would provide information on costs and savings.

For the first time in over a decade, total personnel costs were reduced in 1995–96 and in 1996–97.

opinion, the issues raised in audits or in midterm reviews did not warrant any specific intervention by the Secretariat. More details on the results of such audits or reviews are presented in Chapter 2.

Results Achieved and Some of the Impacts

1.46 The deficit has been reduced. It has been reported and we have attested that the deficit in 1996–97 was at some \$8.9 billion. This represented 1.1 percent of the GDP. The government recognizes that along with restraint measures, good performance by the Canadian economy and low interest rates have contributed significantly to this achievement. In the February 1998 Budget speech, the Minister of Finance stated that he expected there would be no deficit for 1997–98, and committed the government to zero deficit for the next two years.

1.47 Reasonable assurance that the government has met or is likely to meet the expenditure reduction targets of Program Review. Information contained in the Public Accounts, provided by the government from time to time, or obtained from central agencies and departments that we have audited leads us to a reasonable assurance that, as of March 1997, departments either have met the expenditure reduction targets of Program

Review or, assuming no change in expenditures, are likely to meet them in the future. One of the reasons for this assurance is that Program Review expenditure reductions are taken out of departmental budgets at the start of each fiscal year. Another reason is that central agencies have in place a complex tracking system to ensure that expenditure reduction targets flowing from Program Review are met. It must be recognized, however, that the funding of new activities will make it a complex task to compare departmental budgets at the end of Program Review in 1998–99 with those of the base year (1994–95) — as was the case in March 1997, when ministers had to provide explanations to Parliament for why overall government expenditures were higher than previously stated targets.

1.48 The salary and wages envelope has been significantly reduced. For the first time in over a decade, total personnel costs were reduced in 1995–96 and in 1996–97 by a total of some \$3.8 billion, which includes year-end reconciling items. As shown in Exhibit 1.5, however, the salary and wages portion of personnel costs was reduced by \$1.6 billion over the same period. Although the major portion of the reduction in salary and wages was the result of work force reductions, as previously mentioned, the amount also includes reductions due to natural attrition

Exhibit 1.5

Total Reduction In Personnel Costs and Salary and Wage Envelope from 1994–95 to 1996–97
(\$ Millions)

	1994–95	1995–96	1996–97	Total Reduction
Personnel Costs	\$19,155	\$16,747	\$15,358	\$3,797
Salary and Wages Envelope *	\$15,807	\$15,287	\$14,239	\$1,568

* The salary and wage envelope (SWE) is a component of personnel costs and does not include certain types of allowances such as those used to compensate employees for certain expenses, specific duties, or work in isolated locations. In addition, the SWE does not include the employer contributions to various pension and benefit plans.

Source: Public Accounts of Canada and Receiver General of Canada

and employees transferred out of the public sector, and the effect of salary/wages paid to new employees hired during the same period (paragraph 1.39). According to the government, as of March 1997, the incremental costs of departure incentive programs represented some \$1.8 billion (Exhibit 1.6).

1.49 Financial incentives: contributing significantly to the reduction of the work force, but generous overall.

Between February 1992 and March 1997, some 46,000 individuals, including military and RCMP members, benefited from various departure incentive programs (Exhibit 1.7). We found in general that incentives offered by the federal government under various programs were relatively generous. For example, research indicates that termination benefits given by some Canadian organizations in the public and private sectors include an average maximum up-front cash payment equivalent ranging from 36 to 59 weeks' salary. In the federal government, they tend to be higher (Appendix A).

1.50 Our conclusion about the relative generosity of incentives must be balanced by a number of mitigating circumstances and factors that influenced the design and the level of benefits offered. These include:

- the "premium" that had to be paid for the suspension of the guarantee of a "reasonable job offer" granted in 1991 and

for the fact that, when first imposed, salary freezes were presented as protection against layoffs;

- the strong desire expressed by Treasury Board ministers to maintain labour peace within the public service, to treat employees in a humane and sensitive manner, and to use the labour bargaining process to arrive at a negotiated settlement if possible;

- the desire to reduce the public service by means other than involuntary termination, so as to minimize layoffs. According to experts, incentives designed for voluntary termination tend to be more generous;

- the foreseen magnitude of the downsizing. Generally, according to research, the higher the number of employees to be terminated, the more generous the severance programs tend to be, particularly in a unionized setting;

- the poor prospect of re-employment for certain employees, due to lack of transferable skills or to other constraints such as working in communities where there is little or no possibility of federal or other employment. Coupled with the desire to treat all employees equally across Canada, this resulted in decisions to use the lowest common denominator in determining the incentives;

- the effect that the incentive programs have on each other, given that there are

Our conclusion about the relative generosity of incentives must be balanced by a number of mitigating circumstances and factors.

	April 1995 to March 1996	April 1996 to March 1997	Total
Cash incentive payments *	\$ 681	\$ 343	\$ 1,024
Government contribution for the pension waiver under the Early Retirement Incentive Program	\$ 507	\$ 250	\$ 757
Total incremental costs	\$ 1,188	\$ 593	\$ 1,781

* Cash incentive payments do not include incremental costs incurred because severance was paid at the layoff rate.

Exhibit 1.6

Incremental Costs of Departure Incentive Programs Reported by the Government for the Period from April 1995 to March 1997 (\$ millions)

Source: Public Accounts of Canada and the Secretary of the Treasury Board and Comptroller General

several programs and that they were introduced or reviewed at different times.

1.51 Our review of best practices also indicates that there are significant differences between the federal public service and the private sector as well as other public services in the way incentives have been used. For example, in some other sectors, financial incentives for voluntary termination are offered for relatively shorter periods of time, after which they become unavailable. This encourages targeted employees to retire or leave as soon as possible, which maximizes payroll savings and minimizes the disruptive effects of downsizing on the organization and its remaining employees.

It also avoids creating expectations among employees that such benefits will be normal entitlements upon departure or retirement.

1.52 A significant increase over the estimated cost of incentive programs. In the 1994–95 Public Accounts, the government recorded an allowance of \$2.3 billion for costs of Public Service Restructuring over the next three years, to reflect incremental costs for the cash portion of departure incentive programs and the required adjustment to pension liabilities. In the 1995–96 Public Accounts, the government re-estimated its total costs at \$3.0 billion. In 1996–97 the total costs were again revised to

Exhibit 1.7

Number of Recipients by Key Departure Incentive Program – February 1992 to March 1997

Departure Incentive Programs	Period	Recipients	Total Costs Cash Payments ¹ (\$000)	Average Cash Payment	Source
Force Reduction Program (FRP)	1992–1997	13,846	\$ 470,560 ²	\$ 33,985	from DND; audited
Civilian Reduction Program (CRP)	1994–1996	7,369	\$ 314,483	\$ 42,676	from DND; audited
RCMP – Work Force Adjustment	1994–1997	843	\$ 40,017	\$ 47,470	from RCMP; audited
RCMP – Executive Plan	1995–1997	22	\$ 1,605	\$ 72,955	from RCMP; audited
Early Retirement Incentive (ERI)	1995–1997	7,925	\$ 255,490 ³	\$ 32,238	from TBS Reduction File
Early Departure Incentive (EDI)	1995–1997	7,540	\$ 308,242	\$ 40,881	from DND and TBS Reduction File
Work Force Adjustment Directive (WFAD)	1995–1997	2,257	\$ 56,396	\$ 24,987	from RCMP and TBS Reduction File
Executive Employment Transition Policy (EETP)	1995–1997	264	\$ 20,372	\$ 77,167	from TBS Reduction File
Alternative Delivery Incentive (ADI)	1995–1997	6,030	\$ –	\$ –	1997 AG Report, Chapter 19
Privatization, Canada Communication Group	1996	422	\$ –	\$ –	1997 AG Report, Chapter 20
TOTAL		46,518	\$1,467,165		

Total cash payments are those payable as indicated in Appendix A but exclude severance, which totaled some \$810 million.

² This amount does not include accrued annual leave and relocation costs paid under FRP, for a total of \$283 million.

³ This amount does not include the pension waiver costs estimated at between \$800 million and \$900 million for this group.

\$3.2 billion. Of this amount, \$1.8 billion is for adjustments to pension liabilities.

1.53 It is not possible to measure the precise extent to which incentives have contributed to savings. The difficulties we have noted — tracking expenditure reductions over a four-year period during which the expenditure base changed significantly, and deficiencies in the design and application of payback and the reporting structure — inhibits a rigorous assessment of the direct contribution the various incentives have made to expenditure reductions in salary and wages.

1.54 The public service has been reduced significantly. According to the Treasury Board Secretariat, from March 1995 to March 1997 the public service (excluding military personnel and RCMP members) saw a net reduction of over 31,000 employees, from 225,619 to 194,396 — a reduction of about 14 percent (see Exhibit 1.8). The number of indeterminate (permanent) employees has been reduced from 194,733 to 164,111, a reduction of more than 30,600 or 16 percent.

1.55 The profile of the public service has changed considerably. Our review revealed that some occupational groups have been significantly affected by work force reductions, as shown in Exhibit 1.9. The exhibit shows the population of

indeterminate employees in each group at March 1995 and March 1997, the net reduction, and the number of incentives paid to employees in the group. It must be noted that work force reductions may affect some departments more than others. For example, as noted in Chapter 2, indeterminate science and technology personnel were reduced in Natural Resources Canada and Environment Canada by 23 percent.

1.56 Because of the reported effects of the “brain drain” and shortages in some occupational groups, we have reviewed the use of incentives in the Auditor (AU), Computer System (CS) and Executive (EX) groups to determine the impact on the profile of the group, on natural attrition and the total separation rate (normal attrition and departures with incentives). Separate employers were excluded from our review because they often use different occupational groupings. Exhibit 1.10 provides details of our findings.

1.57 The results of our reviews lead us to conclude that incentives have had a negative impact on natural attrition among executives and computer specialists but not among auditors, although the total separation rate was relatively high. This leads us to believe that the management of work force reductions for critical occupational groups such as Computer System or Executive, where there are

It is not possible to measure the precise extent to which incentives have contributed to savings.

Exhibit 1.8

**Evolution of Employment Profile in the Public Service
March 1995 to March 1997**

	At March 1995	At March 1996	At March 1997	Evolution from March 1995 to March 1997
Total number of indeterminate employees	194,733	179,455	164,111	(30,622)
Total number of term and casual employees	30,886	28,522	30,285	(601)
Total number of employees in the public service	225,619	207,977	194,396	(31,223)

Source: Treasury Board of Canada – Employment Statistics for the Federal Public Service

The management of work force reductions for critical occupational groups may require a more global approach.

shortages in some departments and surpluses in others, may require a more global approach than is used for core occupational groups in any department. For example, the basis for declaring an employee surplus in critical occupational groups could be the lack of work overall, instead of in a specific department. Perhaps special interdepartmental mechanisms could be created to manage the process for critical occupational groups. As mentioned earlier, Joint Adjustment Committees have facilitated the placement of surplus employees among departments in the regions, but this mechanism was less effective in the National Capital Region.

1.58 The age structure of the public service has also been affected considerably, although the average age has remained substantially unchanged. As a group, the public service is now more middle-aged, the result of many older and more experienced employees having opted to retire or to leave the public service at the same time as many younger employees left. In the follow-up to our 1994 audit of the management of scientific personnel, we noted a similar phenomenon. The change in the age profile represents a significant challenge for the future, notably the need to address succession planning and recruitment.

Exhibit 1.9

Occupational Groups in the Public Service Most Affected by Work Force Reductions and the Related Use of Departure Incentive Programs (Indeterminate Employees)

	Population at March 1995	Population at March 1997	Net Reduction (1995-97)	Number of Incentives Paid
Technical Groups				
Air Traffic (AT)*	2,411	11	(99%) 2,400	2,379
Electronics (EL)*	2,560	1,245	(51%) 1,315	1,290
Radio Operators (RO)*	1,292	307	(76%) 985	1,033
Engineering and Scientific Support (EG)	6,479	5,188	(20%) 1,291	1,223
Administrative Groups				
Secretarial (ST)	7,590	5,411	(29%) 2,179	1,259
Clerical (CR)	36,664	30,919	(16%) 5,745	5,170
Administrative Service (AS)	14,890	13,168	(12%) 1,722	2,103
Program Administration (PM)	32,997	30,781	(7%) 2,216	2,747
Professional Groups				
Educator (ED)	979	674	(31%) 305	279
Operational or Trades Groups				
General Services (GS)	5,884	3,878	(34%) 2,006	1,820
General Labor (GL)	9,878	7,091	(29%) 2,787	2,286

* These occupational groups have been significantly impacted by the commercialization of the air navigation system.

Source: Incumbent File

Exhibit 1.11 shows the age profiles of the public service in 1993, 1995 and 1997.

1.59 The employment profile of the public service — that is, the ratio of indeterminate staff to other forms of staff employment — has also changed, but it is not clear whether this will be temporary or lasting. For example, we noted that after an initial reduction, the number of casual and term employees increased. The same trend was noted in the temporary assistance costs for the public sector. A 1995 Treasury Board Secretariat guide on comparing the costs of various approaches to meet the demands for administrative personnel concluded that while temporary assistance, for example, may be cost-effective in the short term, this is not the case over the longer term.

1.60 From 1994–95 to 1996–97, costs for contracting or consulting services increased relative to costs of salary and wages. Contracting and consulting services increased by some 14 percent, while salary and wages decreased by 9 percent. Some \$2.2 billion was spent on contracting and consulting services in 1996–97. Since many factors and variables influence the decision to contract for services, it is not possible to draw any macro-level conclusion about the use of contractors as substitutes for public servants. However, we noted the following:

- In 1995, the Treasury Board Secretariat was sufficiently concerned about certain contracting practices to issue specific guidelines to departments outlining unacceptable practices,

The employment profile of the public service has changed, but it is not clear whether this will be temporary or lasting.

We compared the fluctuations in the population of indeterminate employees in these occupational groups between April 1994 and March 1997 to assess the full impact of incentives. We have noted the following:

- **Auditors (AU)** The vast majority — some 450 or 94 percent — of the Auditors who left the public service between April 1994 and March 1997 left without an incentive. Although some individuals (30 or six percent) did receive an incentive, they were generally isolated cases throughout Canada or in Ontario. We have noted also that new recruits have dropped significantly between 1994 and 1997 when compared with previous years. There were some 5,100 employees in this occupational group in March 1994 and the same number in March 1997. Incentives did not have a significant impact on natural attrition or the total separation rate.
- **Computer System (CS)** The number of individuals in the Computer System group increased by some 900 from 6,200 in April 1994 to some 7,100 in March 1997. In 1994–95 natural attrition was approximately two percent and below that of the public service. Natural attrition increased to 3.5 percent, that is, above that of the public service, which was at some two percent in 1995–96 and in 1996–97. During the same period, however, some 430 Computer Systems Specialists also received an incentive to leave or retire from the public service. Natural attrition dropped but the total separation rate increased to some six percent. The majority of those who left with incentives were at the CS 2 and CS 3 levels in the National Capital Region. During the same period, some 650 individuals were recruited, mostly at the entry level (CS 1). In October 1997 the government signed a collective agreement that included lump sum payments to entice Computer System Specialists to remain in the public service. Furthermore, it has been reported that as many as 2,000 Computer System Specialists may be required to deal with the Year 2000 issue.
- **Executive (EX)** Between April 1994 and March 1997 the number of Executives dropped by some 600 or 16 percent, from some 3,850 to some 3,250. In 1994–95, natural attrition was higher than that of the public service, ranging from 6 to 15 percent depending on the level. Between March 1995 and March 1997, some 500 Executives left without any incentive while some 650 received incentives. The majority left with an early retirement incentive but a significant number left with an incentive under the Executive Employment Transition Policy (see Appendix A). Natural attrition for the Executive Group dropped to approximately three percent, but the total separation rate was between 7 and 10 percent depending on the level. Between 1995 and 1997, some 80 Executives were recruited externally, many at the EX 1 level.

Exhibit 1.10

The Impact of Incentives on Auditors, Computer System Specialists and Executives

Source: Incumbent File and Mobility File

There is evidence that as planned and designed, incentives have minimized involuntary layoffs.

particularly those involving contracting for the services of former public servants.

- Although departments were asked to monitor the situation and to include it in the scope of their midterm reviews, a number did not.
- Some midterm reviews or departmental audits identified issues that involved contracting with former public servants. The extent of the problem was not documented in the reports.

1.61 The situation needs to be monitored and studied to determine whether casual and term employment, temporary assistance, consulting and contracting are used in specific cases because they are cost-effective or for purposes that may not be cost-effective, such as to demonstrate savings in salary and wages in order to meet the payback requirements, or to bypass restrictions on hirings.

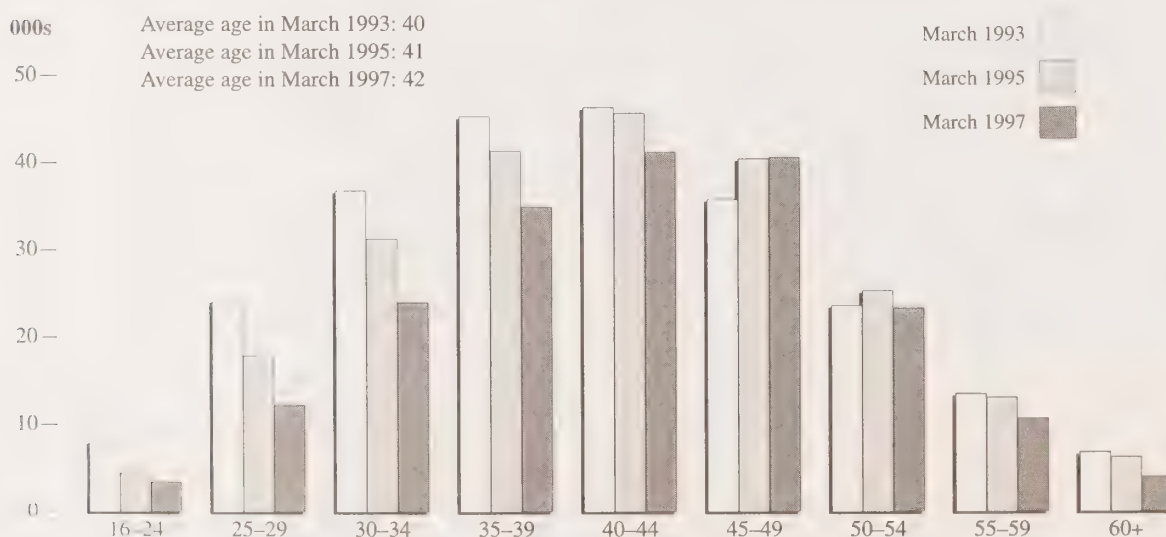
1.62 Incentives have been effective in minimizing involuntary layoffs. There

is evidence that as planned and designed, incentives have minimized involuntary layoffs. Although the Public Service Commission reported that as of March 1997 some 970 employees had been laid off, according to Treasury Board Secretariat officials more than half of these employees had, in fact, been transferred through a devolution of activities to other levels of government, such as the transfer of airports to local authorities.

1.63 Few recipients of incentives are coming back as employees. Generally speaking, there is nothing to prevent employees who received incentives from being rehired or reappointed after a period of time normally equal to the one for which they received an incentive. However, rehiring soon after the payment of an incentive may indicate that there was poor planning or that a surplus situation had not really existed. Given the cost of the incentives to the taxpayer, we would expect rehiring to be minimized.

Exhibit 1.11

Variations in the Age Profile and the Average Age of the Federal Public Service March 1993, 1995 and 1997



Source: Treasury Board Secretariat reports, "Employment Statistics for the Federal Public Service"

1.64 Overall, we found that from 1992 to March 1997 some 600 individuals (including military and RCMP members) who had received incentives had returned in some capacity. The majority of employees returning were in the Department of National Defence—military personnel hired as public servants, for example. (More details are included in Chapter 2, which discusses our findings in specific departments.) The majority of individuals were hired back as casual or term employees in the public service, but some came back as indeterminate employees. Casual employees are limited to a maximum of 90 days' employment per contract and to 125 days in a 12-month period. We found 11 cases of individuals rehired who had received more than one incentive. In spite of this, we believe that overall the situation has significantly improved since 1992, when we reported that some 800 out of some 13,000 individuals who had received incentives had been rehired in some capacity.

1.65 Many public servants are interested in receiving incentives. Information obtained from Joint Adjustment Committees indicates that at March 1997, for each of the more than 1,400 public servants officially declared "affected," there were three more who were ready to "swap" jobs in order to become eligible to receive a financial incentive and leave or retire from the public service. This ratio was higher in the National Capital Region: five to one. These ratios are conservative since, for example, the numbers reported by the Committees include only individuals for whom management agreed to approve the swapping if the opportunity arose. Furthermore, in the National Capital Region not all departments agreed to participate in the activities of the Joint Adjustment Committees. Our examination of grievances, periodic complaints received and interviews with some union officials lead us to believe that, overall, significantly more individuals were

interested in receiving financial incentives and leaving or retiring from the public service than the numbers reported by Joint Adjustment Committees would suggest. In our opinion, this indicates not only that the incentives were attractive but also that not all is well in the public service.

1.66 A number of issues need to be addressed. Now that the fiscal crisis has in many respects subsided, other mechanisms are being used to deal with outstanding or new issues flowing from Program Review. The special committee structure put in place for Program Review no longer exists. The change process has now been integrated into management systems such as the Expenditure Management System, or is taking place through initiatives such as La Relève, aimed at dealing with human resources issues in the public service.

1.67 Although the formal Program Review exercise will end in 1998–99, we believe that a number of issues have yet to be addressed and that significant efforts are still required. For example:

- It has been recognized that many policy issues must be viewed from a more horizontal perspective rather than simply a departmental one.
- There is a continuing need for better quality and consistency of information on, for example, the costs and cost effectiveness of programs and services or on expenditure and work force reductions.
- Important efficiency issues need to be addressed, which could result in hundreds of millions of dollars in savings. Exhibit 1.12 provides illustrations of areas where efficiency gains have been identified by this Office and by the government.

1.68 The need to address a number of human resource issues has been amplified. Our audit work for this chapter and our 1997 chapter, *Maintaining a Competent and Efficient Public Service*, as well as the Fourth Report of the Clerk

Work force reductions have amplified or made more evident the need to resolve pre-existing and new human resource issues.

of the Privy Council and Head of the Public Service, reveal that work force reductions made to implement expenditure reductions have amplified or made more evident the need to resolve pre-existing and new human resource issues. There is a consensus on the need to:

- adopt longer-term and more strategic plans for human resources, in order to have the right people with the right skills at the right time;

- modernize and simplify human resource systems, notably the classification and job evaluation system and the collective bargaining and staffing systems, as we reported in 1996 and 1997;

- address horizontal issues such as training, hiring and transfer processes in order to improve mobility and career opportunities. Joint Adjustment Committees (paragraph 1.34) might

Exhibit 1.12

Examples of Opportunities for Improved Efficiency

(identified by this Office and by the government)

Cost and expenditure reduction can be attained in several ways, such as work force reductions, privatization and devolution of activities. In addition, efficiency gains, cost recovery and revenue generation can offset the need to reduce expenditures. For instance, having cost savings as a performance indicator has been shown to have a positive impact on cost effectiveness.

Examples of potential for improved efficiency reported in previous audits by our Office

- Opportunity for tens of millions of dollars in savings as part of improvement in the management of the Canada Pension Plan Disability Program, major capital projects and export development activities.
- Potential savings of hundreds of millions of dollars in holding costs, related to improvement in the government's materiel management practices, and savings in cost of travel.
- Potential for the cost recovery of expenditures, as in the case of Parks Canada canal operations.
- Allocation of additional resources to tax recovery in higher-risk areas and to combat tax avoidance.
- Opportunity to increase cost effectiveness by improving risk management associated with large systems under development, and improving use of telecommunications.
- Opportunity to generate additional savings in the millions by giving consideration to contracting-out practices and exposing internal functions to competition in such areas as infrastructure maintenance, translation and fleet management.
- Opportunities continue to exist to further simplify and/or reduce the cost of classification and job evaluation and some of the related systems and practices, such as pay administration.

Examples of potential for improved efficiency identified by the government

The government has also looked at modernizing its operations. Various deputy minister task forces looked at different aspects of public administration, such as service delivery, administrative support and addressing horizontal issues. The following are examples of efficiency issues raised:

- Improved services to clients and efficiency gains by better integrating and grouping of services using the "one-stop shopping" concept.
- Improved integration and efficiency of service delivery by the establishment of better interdepartmental and intergovernmental mechanisms and partnerships.
- Increase in the use of shared systems and practices, in particular for administrative and support systems, which could produce significant savings.
- Reinforcement of project pre-selection criteria including a potential for cost savings.
- A reduction in the number of collective bargaining groups.
- Opportunity for cost efficiency in the order of \$25 million annually in pay and benefits administration, by information sharing and use of information technology.
- Estimated savings of \$250 million over five years in streamlining and improving the procurement and payment process.

provide an interesting avenue to address some of these issues;

- address rejuvenation and renewal issues, if the public service is to have people with the skills and experience required for the next century while compensating for the loss of experienced professionals and corporate memory;
- address shortages in such groups as policy analysts, economists, auditors, computer system specialists, financial officers, mathematicians, statisticians and engineers — shortages created by the exodus of high-potential employees and the combination of incentives and increased natural attrition that have depleted the ranks to sometimes below critical levels;
- better manage the situation of employees who remain and who feel less secure after work force reductions and after having had their compensation frozen for six years. This can be done, for example, by redesigning work processes, monitoring increases in workloads and stress levels, and addressing low morale and low motivation;
- find ways to return to a more “normal” situation where incentives are used sparingly. In our opinion, an “entitlement” mentality has been created by some 13 years of departure incentives; many public servants have high expectations of being able to benefit from such incentives upon retirement or upon leaving the public service.

Conclusion

Program Review: A Success from Many Perspectives

1.69 From the perspective of central agencies, Program Review has been a success. The government was able to achieve the significant expenditure reductions it estimated were required, and

the process ensured significant buy-in from individual ministers and senior officials because they were given the responsibility for deciding on expenditure reductions within the context of fiscal targets.

1.70 According to senior officials, the exercise has led to a considerable rethinking and realignment of government programs to ensure greater relevancy and affordability. In their opinion, Program Review has contributed to making the new Expenditure Management System more focussed on results and impacts than on inputs, and has contributed to a significant restructuring of the public service.

1.71 In spite of a difficult climate, expenditure and work force reductions were implemented without major work disruptions. Furthermore, employee representatives were involved in many aspects, from negotiating incentives to participating actively in Joint Adjustment Committees. Implementation is reported to have made senior officials more aware of the importance of people and of the need to significantly transform and enhance the way people in the public service are managed. This has led to the candid admission by the Head of the Public Service that there is now a “quiet crisis”, the result not just of recent work force reductions but of years of neglect; strong actions are required to ensure that the public service remains a vibrant institution.

1.72 On the basis of our review and our examination, and when compared with previous attempts, we conclude that Program Review decisions have, up to now, been implemented successfully in many respects. As noted in this chapter and Chapter 2, however, there were also difficulties and shortcomings. Moreover, the cost of achieving work force reductions was high, not simply in dollar terms but in human terms as well. The task of “Getting Government Right” is not finished.

In our opinion, an “entitlement” mentality has been created by some 13 years of departure incentives.

We conclude that Program Review decisions have been implemented successfully in many respects.

More effective mechanisms are required to improve the interdepartmental management of work force reductions in certain occupational groups.

There is now ambiguity about the respective accountability of departments and central agencies in relation to the cost-effective management of work force reductions.

Substantial Efforts Are Still Required

1.73 The management of work force reductions and departure incentives needs to be improved in a number of situations. Our audit work in relation to occupational groups, for example, leads us to conclude that more effective mechanisms are required to improve the interdepartmental management of work force reductions in certain occupational groups where there may be genuinely surplus employees in one department but where vacant positions or a shortage of the same skills exist in another.

1.74 Another kind of situation that, in our opinion, calls for improved management of work force reductions is that of an organization whose units or parts differ in the status of management of their human resources — one part for which the Treasury Board is the Employer, for example, and another part that has separate employer status. When positions are vacant and skills are easily transferable, or when some functions in DND or the RCMP, for example, can be performed by military or civilians interchangeably, the work force should be managed more globally and strategically. In our opinion, if such an approach had been followed it would likely have resulted in a more cost-effective use of incentives.

1.75 Accountability to Parliament for Program Review and related work force reductions needs to be strengthened. This chapter has highlighted the difficulty of consolidating and reconciling information originating from various sources on work force reductions and the costs associated with departure incentives. We have expressed the view that this limits the government's ability to account completely and comprehensively for the results achieved.

1.76 Although central agency officials and others consider Program Review quite

successful so far, full implementation will not be completed before March 1999. In our opinion, the government's significant commitments to expenditure reductions and the significant costs associated with departure incentive programs require that the government and departments account to Parliament for the results achieved, in a way that is complete, clear, transparent and appropriate. The rendering of accounts especially needs to include results in terms of the expenditure reductions as well as the costs, the expenditure reductions associated with the various departure incentive programs, and their effects on the work force.

1.77 There is a need to clarify roles, responsibilities and accountabilities of central agencies and departments in the management of work force reductions. What Program Review clearly demonstrates is that, within the context of broad direction from central agencies, departments are often in the best position to determine what specifically is needed and should be done to implement government decisions in a cost-effective way. For example, in the context of work force reductions, some departments have negotiated with employee representatives the nature and the level of the incentives required. The role of central agencies, in particular the role of the Treasury Board and its Secretariat as the Employer, has also been evolving for some time (paragraph 1.32). In our opinion, there is now ambiguity about the respective accountability of departments and central agencies in relation to the cost-effective management of work force reductions. The framework proposed for work force reductions states that departments will be held accountable for the prudent and cost-effective management of departure incentive programs. However, much needs to be done to clarify the roles, responsibilities and accountability relationships at the central agency and departmental levels.

1.78 There is a need for visible and sustained political leadership and involvement in addressing the “quiet crisis” facing the public service. One lesson to be learned from Program Review and its implementation is the importance of sustained leadership and involvement at the political level, if significant change is to take place. Strong political resolve, a clear objective that provides focus, the involvement and participation of individual ministers working closely with their officials — all were essential ingredients in the success of Program Review.

1.79 It is not evident that there is the same visible leadership, involvement, consensus and resolve at the political level to address the “quiet crisis”, and to address public service management issues flowing from expenditure and work force reductions and the rethinking of government programs. Program Review has made it abundantly clear that the ability of governments to successfully tackle a crisis, fiscal or otherwise, depends to a significant extent on the competence and effectiveness of the public service.

Various studies and reports, including our 1997 chapter, *Maintaining a Competent and Efficient Public Service*, have pointed to the fact that the institution is under significant stress. What is also clear is that unless strong actions are taken, there is a risk that the public service of the future may not be as capable of providing Canadians and successive governments with the best possible professional, loyal and non-partisan service.

1.80 Our concern is that the ability of public servants to effect significant change is limited, because they have to operate within existing frameworks and the means and resources at their disposal. For example, the current legislative framework does not allow for the significant changes considered necessary by many stakeholders to reform and simplify the staffing system in the public service. Many previous attempts at reforming human resource management in the public service have failed, in particular, because there was a lack of political leadership, consensus, involvement and resolve.

One lesson to be learned from Program Review and its implementation is the importance of sustained leadership and involvement at the political level, if significant change is to take place.

Appendix A: Summary Description of Departure Incentive Programs

Incentive program ¹	Eligibility	Brief benefits description
Work Force Adjustment Directive (WFAD) (From December 1991)	This option is available to surplus indeterminate employees.	<ul style="list-style-type: none"> Severance pay at layoff rates.* Pay in lieu of unfulfilled surplus period for a maximum of six months' pay. Separation benefit (one week's pay for each complete year of service to a maximum of 15 weeks). (This benefit was suspended from July 1995 to June 1998.)
Early Departure Incentive (EDI) (July 95 to June 98)	This option is available to indeterminate employees (excluding executives) who have been declared surplus in "most affected" departments designated by TBS.	<ul style="list-style-type: none"> Severance pay at layoff rates. Lump sum payment of: <ul style="list-style-type: none"> 39 weeks of pay if employee has less than five years of continuous service. 52 weeks of pay if employee has more than five years of continuous service. up to 52 weeks if employee has more than five years of continuous service and is eligible for an unreduced pension. In addition, individuals receive Service Allowance, which consists of up to six weeks of regular pay based on an employee's age and continuous years of employment.
Early Retirement Incentive (ERI) (April 95 to March 98)	<p>This option is available to surplus indeterminate employees (including surplus executives) who:</p> <ul style="list-style-type: none"> have at least five years of pensionable service; have at least 10 years of employment; are at least 50 years old but not yet 60 by the time they leave the public service. 	<ul style="list-style-type: none"> Severance pay at layoff rates. For executives: one week's pay for each completed year of service to a maximum of 28 weeks. Separation benefit (one week's pay for each completed year of service to a maximum of 15 weeks). (This benefit was suspended from July 1995 to June 1998.) Pay in lieu for a maximum of six months' pay. Unreduced pension for employees age 50 to 59 who would otherwise have had their pension reduced by up to 50%.
Executive Employment Transition Policy (EETP) (May 95 to March 98)	This option is available to surplus indeterminate executives.	<ul style="list-style-type: none"> Up to 44 weeks' salary (including severance pay) if the executive has less than 5 years of service. Up to 90 weeks' salary (including severance pay) if the executive has more than 5 years of service but is ineligible for pension or eligible for a reduced pension. Up to 70 weeks' salary (including severance pay) if the executive has more than 5 years of service and is entitled to an unreduced pension.
DND Civilian Reduction Program (CRP) (April 94 to March 96)	This option is available to civilian employees affected by a work force reduction, base/facility closure or relocation of work.	<ul style="list-style-type: none"> Severance pay at the layoff rate as stipulated in the application of the collective agreement. Lump sum payment (12 months of pay, paid in one lump sum upon termination of employment). Cash supplement for those employees with 5 or more years of continuous employment. The combined payments not to exceed 104 weeks. Departure allowance (one week's regular pay for each year of continuous employment to a maximum of 15 weeks or up to \$7,000 training and education option).

¹ Source: adapted from Treasury Board Secretariat guidelines, National Defence and RCMP documents.

* Severance pay varies according to the reason for separation. For example:

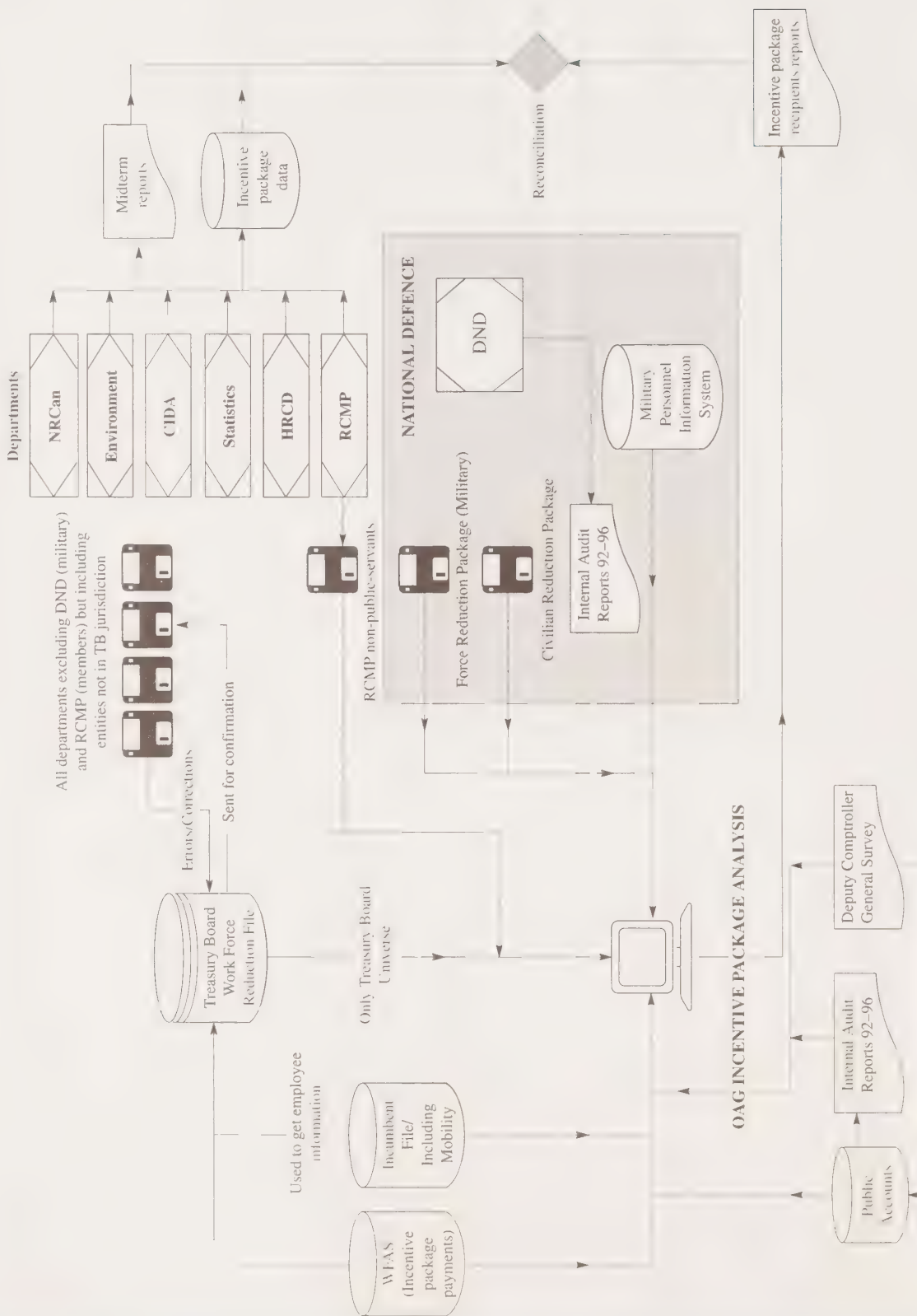
- Retirement = (1 week of pay) x number of years of continuous service to a maximum of 30 weeks.
- Resignation = (1/2 week of pay) x number of years of continuous service to a maximum of 26 weeks.
- Layoff = Nothing paid if less than 10 years of continuous service.
(2 weeks' pay for the first year of continuous service) + (1 week's pay x the number of years of continuous service) with no maximum.

Appendix A: Summary Description of Departure Incentive Programs (cont'd)

Incentive program	Eligibility	Brief benefits description
DND Force Reduction Programs (FRP) (January 92 to March 97)	Regular force members are eligible for this option based on specific: <ul style="list-style-type: none"> • military occupation code; • rank; • years of service. 	<ul style="list-style-type: none"> • Severance pay (one week's pay for each completed year of continuous full-time paid service up to a maximum of 30 weeks or 210 days). • Special leave based on all periods of regular force as of commencement of retirement leave. Benefits vary from 90/180–270 days or 60 days if members are in last year of service.
RCMP Work Force Adjustment (RCMP-WFA) (From March 94)	This option is available to regular and civilian RCMP members (except executives and public service employees).	<ul style="list-style-type: none"> • Severance pay (2 weeks' pay for the first complete year of service, and one week's pay for each additional complete year, to a maximum of 28 weeks. For employees who joined prior to 18 March 1976 the maximum increases up to 30.4 weeks for persons of 35 years or more regardless of whether they were released under WFA or retired voluntarily). • Pay in lieu of unfulfilled surplus period for a maximum of six months' pay. • Separation benefit (one week's pay for each complete year of service to a maximum of 15 weeks except substitutes). • Waiver of pension reduction penalties for early retirement. The magnitude varies depending on type of member, age and year of service, in accordance with the <i>RCMP Superannuation Act</i>.
RCMP – Executives	Option available for all executives (except public service executives).	<ul style="list-style-type: none"> • RCMP does not have a formalized Executive Employment Transition Policy. While its executive packages are determined on a case-by-case basis, the Force has tried to maintain parity with its RCMP-WFAD and the public service Executive Employment Transition Policy.

1 Source: adapted from Treasury Board Secretariat guidelines, National Defence and RCMP documents.

Appendix B Schematic View of the Documentation and Information Used for the Audit



Chapter 2

Expenditure and Work Force
Reductions in Selected
Departments

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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Expenditure and Work Force Reductions in Selected Departments

Main Points

2.1 As a result of a lengthy period of fiscal restraint and recent expenditure reduction programs, some federal government agencies have been abolished, some departments merged and others reduced in size. It is estimated that the public sector work force will have been reduced by approximately 45,000 employees between April 1995 and March 1998.

2.2 We selected seven departments to examine how and the extent to which expenditure reductions have been implemented. These organizations, representing over 170,000 employees, differed in size, structure and reduction targets.

2.3 Generally, departments we reviewed met their 1995–96 and 1996–97 expenditure and work force reduction requirements. Given progress to date, we expect that most of them will meet their reduction targets for the remaining two years of Program Review.

2.4 We found that ministerial commitment and departmental leadership were evident in setting direction and attaining momentum. Factors such as the size of the reduction, readiness for change and the time available to plan had an effect on departments' strategic planning for reduction. Departmental implementation of reduction was generally rigorous and employees were well informed both prior to and during the reduction process.

2.5 Although most reduction targets were met, and overall compliance with work force reduction policies had improved since our 1992 Report chapter, Payments to Employees under the Work Force Adjustment Policy, we found questionable actions in some departments. The need for incentive packages was not always well researched and there was a tendency to call for volunteers prior to identifying positions surplus to requirement. Best practices suggest that an organization should conduct a thorough cost/benefit analysis of alternatives; target incentives to areas where they are needed most; and identify the extent to which there is a need to call for volunteers.

2.6 Departments focussed primarily on meeting reduction targets in a timely manner. Less emphasis was placed on cost management. Such factors as the initial lack of necessary financial and human resource information, departments not having to fund entirely the departure incentives they provided, and an unclear Treasury Board Secretariat accountability structure for departmental work force reduction costs contributed to a general lack of cost consciousness in departments.

2.7 Throughout work force reduction, departments treated departing employees in a humane and sensitive manner. Departments paid less attention generally to those who remained and to their concerns regarding the loss of experienced and qualified colleagues, the level of workload per employee and future departmental direction. Departments have now entered a period of transition that will require not only adjusting organizational structures and operations but also paying particular attention to ensuring that work force capability meets future operational demands.

Introduction

2.8 Fiscal restraint measures and public sector work force reductions have influenced the development and delivery of federal programs and services for a number of years. However, recent initiatives — for example, the 1993 government restructuring; various policy reviews in areas such as defence, science and technology, foreign affairs and social policy; and Program Review — have reshaped the roles, structures and activities of the federal government to an extent not seen since the period following the Second World War.

2.9 Collectively, these initiatives have led to a significant reduction in the costs of the federal government and the size of the federal public service. The changes have affected in quite different ways the many entities that make up the federal public sector. Some government agencies have been abolished, several departments have been merged, and almost all existing departments and agencies have had their budgets reduced — some very significantly.

Focus of the Audit

2.10 Chapter 1 reviewed the evolution of expenditure and work force reduction over the years, and discussed the role that central agencies played in the implementation of government-wide reductions. This chapter focusses on the way reductions were carried out by selected departments and agencies (hereinafter all referred to as departments). We selected seven departments for detailed audit work: the Canadian International Development Agency (CIDA); the Royal Canadian Mounted Police (RCMP); Statistics Canada (StatsCan); Department of National Defence (DND); Environment Canada (ENV); Human Resources Development Canada (HRDC); and Natural Resources Canada (NRCan). They

represent a work force of some 170,000 public servants, military personnel and RCMP members, and they differ both in the size of the reductions they were required to make and the approaches they took.

2.11 Our examination focussed primarily on these seven selected departments. Where appropriate, we relied on reviews or audits carried out on behalf of central agencies or by the seven departments themselves. We also reviewed current studies and reports to identify relevant best practices in both the public and the private sectors in Canada, as well as in other countries such as the United States, Australia and New Zealand. These best practices provided a framework within which to identify lessons learned for the future. We examined the extent to which each department has applied these practices (see Exhibit 2.1).

2.12 Our audit focussed primarily on expenditure and work force reductions during the period from April 1995 to March 1997. In the case of DND, however, the audit covered the period from 1991 to 1997 in order to include significant military reduction activities not covered in our 1992 Report chapter, Payments to Employees under the Work Force Adjustment Policy. Our audit of the RCMP covered the period from April 1994 to March 1997.

2.13 Members of the Canadian Forces are subject to different obligations and terms of employment from those governing their public service counterparts. For instance, Canadian Forces members are not protected by the Work Force Adjustment Directive (WFAD) and as a condition of service may be relocated at any time. Nor does the directive protect uniformed and civilian members of the RCMP. Further details are presented at the end of this chapter, in the section **About the Audit**.

Recent initiatives have led to a significant reduction in the costs of the federal government and the size of the federal public service.

Observations

The challenges faced by departments were significantly different

2.14 When Program Review was launched in May 1994, many departments and agencies were already undergoing major changes. For example, a government-driven reorganization in June

1993 necessitated a realignment of policies, programs, activities and systems in several departments. At least one quarter of the cuts to operating budgets were to come from savings in administration. In addition, horizontal initiatives such as the Science and Technology Review and the Social Policy Review were under way, affecting many departments involved in those sectors.

Exhibit 2.1

Expenditure and Work Force Reduction Best Practices

Leadership

Expenditure and work force reductions require sustained, active and visible leadership. It is essential that managers and employees alike know the reasons for the reductions, the challenges facing the organization, and that the situation can and will be managed with a continuing sense of purpose and direction.

Strategic planning

If lasting expenditure reduction is to be achieved, attention needs to be paid to fundamentally rethinking the organization, its role, objectives, delivery mechanisms, structure, operational capabilities and processes.

Selecting the best approach to work force reduction

Once an organization decides to reduce its work force, a cost/benefit analysis of alternatives is needed to determine the degree to which employee departure incentives should be used. When incentives are used, consideration should be given to: targeting incentives to areas or jobs where cuts are needed most; identifying the extent to which individuals will be targeted or volunteers will be called for; and limiting the duration of the incentive offer.

Implementation

Most organizations create a special structure, team or committee, free from operational distraction, to focus reduction decisions and co-ordinate implementation activities. These structures are usually under the direction of a senior manager and composed of people with the line and staff knowledge and competencies to ensure progress over a short time frame.

Communications

Reduction initiatives require clear and effective lines of communication between management and staff as well as with other key stakeholders (the Minister, employee representatives, the media and external parties). Information provided and received should be clear, accurate, consistent, and timely.

Treating employees in a humane and sensitive manner

It is essential that management minimize the negative effects of work force reduction on both employees departing and those remaining. Employees departing should be informed as early as possible of their employment termination status, their options and their legal rights. In addition, they should receive necessary transition assistance such as career and financial counselling, training and other personnel services. Managers and employees remaining will need to understand the impact of reduction on their work and workload, and the adjustments planned to address these changes.

Monitoring and measuring progress

Monitoring and evaluation mechanisms are needed to ensure that reduction is progressing as planned; the desired results are achieved in a timely and cost-effective manner; and there is compliance with approved policies and guidelines.

2.15 Many departments that we selected were already facing challenges prior to Program Review. The changes each department was experiencing varied due to such factors as the size and geographic dispersion of the work force, the level of reduction required and the options or tools available to address the needed change. The following gives an indication of the renewal and re-engineering activities under way in each of the selected departments:

- Between 1989 and 1993, DND implemented six budget reductions totalling \$14 billion. This required it to scale back most activities, close installations and reduce military and civilian personnel by 14,000 and 3,000 respectively. In addition, a 1993 review of Canada's Defence Policy brought about an additional budget reduction of \$7 billion. At the same time, several renewal and re-engineering initiatives were under way. Projects focussed on such areas as changes to infrastructure, base closures, functional reviews of headquarters and increased delegation of authority.
- In June 1993, NRCan became a new department composed of the former departments of Forestry and of Energy, Mines and Resources. In addition to reducing administrative overhead, several of its sectors had initiated fundamental reviews of their missions, priorities and approaches. They also were adjusting to the termination of energy megaproject funding as well as some funding agreements with the provinces.
- HRDC became a new department in June 1993, taking in all or part of four former departments. This reorganization brought income support programs together with human resource development programs and linked it all to national economic and labour market requirements. Fiscal year 1994–95 was a year of transition, with organizational restructuring and reforms to the social security system. As HRDC was

implementing its Income Security Program Redesign, it was initially excluded from Program Review.

- During the summer of 1993, Parks Canada separated from Environment Canada. This reduced the latter's full-time-equivalent staff by half, and marked the beginning of a significant restructuring initiative. The Department was also changing its structure and focus with the implementation of the Green Plan.
- The RCMP had been engaged in three major change initiatives — reducing its operating budget, restructuring its headquarters operations and redesigning its provincial and municipal policing operations in several provinces.
- In response to a change in Canada's foreign policy, CIDA had been implementing a long-term strategic initiative that entailed reassessing its policy and program direction, streamlining decision-making and delivery processes, changing its relations with stakeholders, and examining better people-management practices as well as cost reduction.
- Before Program Review, Statistics Canada had completed a series of expenditure reductions in 1992–93. It faced a further reduction of 2 percent in its operating expenditures starting in 1994–95, increasing to 7 percent by 1997–98. In addition, it had the challenge of planning and resourcing the five-year cyclical project for the 1996 census. The agency had also developed a corporate planning and monitoring capability that would assist in rethinking program delivery, seeking increased efficiencies and opportunities for revenue generation.

2.16 In addition to previous reduction requirements, the magnitude of required expenditure reductions from 1995–96 to 1998–99 during Program Review varied for each department selected. Exhibit 2.2 summarizes the level of required

Many departments that we selected were already facing challenges prior to Program Review.

expenditure reduction for each department to 1998–99.

2.17 The options and strategies used to meet reduction requirements varied significantly among the departments examined. Some departments used work force reductions in a significant way to accomplish their expenditure reductions, while others (CIDA and StatsCan) did not use this option to the same extent. Some departments sought to augment their available funds by means of alternatives such as user fees, partnerships with stakeholders or cost-sharing arrangements. However, the possibility of placing greater reliance on such alternatives depended largely on the nature of the department's

programs and activities, and its ability to identify willing partners.

Leadership

2.18 Expenditure and work force reductions require sustained, active and visible leadership from senior management. Leadership for change of this magnitude cannot be examined in isolation. It is most often demonstrated as a part of such management responsibilities as planning, communications and implementation, as discussed in subsequent sections of the chapter.

Exhibit 2.2

Budget Reduction Targets for Selected Departments

(includes Program Review targets and reductions announced prior to Program Review)

	1994–95 Main Estimates (\$ millions)	Reduction Targets (\$ millions)					% Total of 1994–95 Main Estimates
		1995–96	1996–97	1997–98	1998–99	Total	
DND	11,545	(576)	(410)	(1,331)	(447)	(2,764)	(24)
HRDC ¹	3,918	(625)	(511)	(16)	(74)	(1,226)	(31)
NRCan ²	1,012	(25)	(54)	14	(15)	(80)	(8)
ENV ³	737	(47)	(59)	(48)	(17)	(171)	(23)
RCMP	1,197	(32)	(20)	(23)	(59)	(134)	(11)
CIDA ⁴	2,027	(312)	8	(138)	(117)	(559)	(28)
StatsCan	282	(11)	(6)	(7)	(8)	(32)	(11)
Total	20,718	(1,628)	(1,052)	(1,549)	(737)	(4,966)	(24)

Notes:

- ¹ The Main Estimates for HRDC exclude non-discretionary Old Age Security payments and provincial/territorial transfer payments. Funding it receives for administration of Employment Insurance has been included.
- ² Since 1994–95 NRCan has faced significant reductions in its Main Estimates due to termination of sunset programs such as forest resource development agreements and the winding down of megaprojects. These add approximately \$360 million to NRCan's reductions, bringing its total reduction to about 43% of its 1994–95 Main Estimates.
- ³ Environment Canada has also faced significant Main Estimate reductions due to sunseting Green Plan initiatives, adding approximately \$60 million to its reduction and bringing its total reductions to 31%.
- ⁴ CIDA reduction targets are approximately 80% of the total allocation to the International Assistance Envelope.

Source: Treasury Board Secretariat, 1994–95 Main Estimates Part II and departments

Senior management participation in reduction was evident

2.19 Senior management involvement and participation in expenditure reduction was evident in the organizations we reviewed. Ministers and senior departmental officials (deputies and executive committee members) provided a sense of direction from the outset and maintained momentum throughout the reduction process.

2.20 In all seven departments, deputies played a key initial leadership role in preparing, planning and implementing expenditure reduction decisions. In most cases, they established special task structures — which reported to the departmental executive committee and were headed by senior executives — to co-ordinate planning and implementation.

2.21 The following are some illustrations of leadership approaches demonstrated in the departments we examined:

- The Deputy Minister of Environment Canada exercised leadership through both a top-down and a bottom-up approach. He and his senior management team at headquarters developed a Department-wide approach to determining how expenditure reductions would be made under Program Review. Assistant deputy ministers, with regional directors general, managed the bottom-up approach to identifying opportunities for reduction.
- Leadership in the RCMP was best demonstrated by the nature and level of the Commissioner's visibility in all major change and expenditure reduction initiatives across the Force. His visible commitment to change and reduction was particularly important as he led a "Shared Leadership Vision". This was an initiative that sought increased manager and employee input and commitment to the RCMP's mandate, its values and, perhaps most important, the changes and reductions the Force was undergoing.

- In Statistics Canada, the Chief Statistician provided clear direction from the start that expenditure reductions were to be achieved through means such as rethinking and streamlining programs, and other efficiency measures. Senior management was committed to handling reduction initiatives in such a way that employee layoffs and departure incentives would be used only as a last resort.

- In HRDC, unlike other departments, expenditure reduction targets, program priorities and roles were determined by the Cabinet. The majority of the Department's operations had been excluded from Program Review before the February 1995 Budget. As a result, HRDC had about four months — from March to June 1995 — to determine how the expenditure cuts would be implemented. Senior management leadership had to be swift and decisive, given the late start. The Deputy Minister and the Associate Deputy Minister oversaw the development of a new vision, work force reduction plans, a review process and timetables, as well as a system to delegate responsibility for work force reduction decisions across the organization.

Strategic Planning

2.22 Effective reduction initiatives require strategic thinking and analysis. Simply reducing the number of staff or the size of the organization is a short-term solution that is frequently followed by the same or higher levels of resourcing in the long term.

2.23 As we have noted in paragraph 2.15, most departments we examined were already, to varying degrees, rethinking their mission and operations prior to Program Review. Some of these departments retained their previous special planning structures to deal with Program Review. Such strategic initiatives and analyses provided an effective foundation upon which to deal with the

Senior management involvement and participation in expenditure reduction was evident in the organizations we reviewed.

Some departments were better able than others to take advantage of their previous strategic analysis and planning capability.

The key factor for HRDC was time.

challenges of expenditure and work force reduction.

Time frame and size of reductions affected the ability to plan strategically

2.24 In addition to the knowledge departments had gained from previous renewal efforts, the Program Review process itself reinforced a strategic approach. Departments and their ministers were asked to answer six strategic questions that would assist in determining the areas proposed for reduction (Exhibit 2.3).

2.25 Departments also were given three years to implement Program Review. This extended period provided an opportunity to plan and implement reductions more strategically.

2.26 As Program Review began, some departments were better able than others to take advantage of their previous strategic analysis and planning capability. Success was dependent on factors such as the size of their expenditure reduction targets, the amount of time available to plan reductions and the degree of certainty about the extent of reduction. For example, while a short time frame to plan reductions proved advantageous to implementing them swiftly, it also meant

that the ability to plan strategically was limited.

2.27 Departments with smaller reduction targets, such as the RCMP, CIDA and StatsCan, were better able than the others to use their previous experience with change. For instance, the RCMP used a set of Force-wide, previously approved reduction guidelines to determine what to cut first. CIDA used its planned work force reductions to adjust the profile of its work force in line with its new policy and program direction. As a result of previous reduction initiatives, StatsCan chose not to use employee departure incentives as the means to meet Program Review reduction requirements.

2.28 The key factor for HRDC was time. Unlike other departments, HRDC had only about four months to plan the \$2.8 billion expenditure reduction announced in the February 1995 Budget. This translated into staff cuts of 5,000 full-time equivalents. This time constraint limited the Department's strategic options. From the outset, its expenditure reduction became mainly a budget-driven exercise, with priority areas for reduction set by Cabinet.

2.29 Initially there was little understanding of how the HRDC organization would look in the future or the work force skills that would be required. It was difficult to plan, given the uncertainties about the nature of future business lines and about the impacts of initiatives such as the new Employment Insurance legislation, and the new Service Delivery Network involving the closure of about 150 offices across the country. Other emerging changes, such as increased reliance on information technology, overhead cuts in national and regional headquarters and the new labour agreements with provinces, made strategic planning an even greater challenge.

2.30 NRCan and DND, along with other departments, were affected by uncertain final reduction targets. While NRCan benefited from its experience with

Exhibit 2.3

Six Criteria (Questions)
Distributed to Departments at
the Outset of Program Review

1. Does the program or activity continue to serve a public interest?
2. Is there a legitimate and necessary role for the government in this program area or activity?
3. Is the current role of the federal government in this program a candidate for realignment with the provinces?
4. What activities or programs should or could be transferred in whole or in part to the private or the "voluntary" sector?
5. If the program or activity continues, how could its efficiency be improved?
6. Is the resultant package of programs and activities affordable within fiscal restraint and if not, what programs or activities should be abandoned?

previous change initiatives, uncertainty about its Program Review I reduction levels rendered planning more difficult during the months leading up to the 1995 Budget. In DND, the management of reduction initiatives was clearly complicated by continually increasing reduction targets and the corresponding difficulty of defining an end-state structure for the Canadian Forces. National Defence was given four different military reduction targets over the first four years of its reduction program (1991–94). The resulting need to change its plans so frequently hindered its ability to take a strategic approach to downsizing.

Selecting the Best Approach to Work Force Reduction

2.31 Organizations may offer departure incentives to employees affected by work force reduction in order to implement the reductions swiftly, reduce the need for involuntary terminations and minimize labour relations difficulties. At the same time, the implications (including cost implications) of decisions must also be taken into account.

2.32 We examined three areas that relate to selecting the best approach to work force reductions: cost/benefit analysis to determine the need for and content of departure incentive packages; accountability for assessing the cost impact of using employee departure incentives; and selecting the best approach to determining who should receive departure incentives.

The need for departure incentive packages was not well researched in some departments

2.33 Between 1991 and 1995, departments accomplished their staff reductions through the Work Force Adjustment Directive (WFAD) and Executive Employment Transition Policy (EETP). For DND and the RCMP, the situation was somewhat different.

Although military members were not covered by the directive, DND believed it had a moral obligation to provide its members with terms and conditions of employment comparable with those of its civilians. The reductions required DND to determine the need for separate departure incentive packages in consultation with the Treasury Board Secretariat.

2.34 Although the need for DND's civilian departure incentive program in 1994 was established on the basis of a sound analytical framework, planning for its military reduction initiative suffered from insufficient front-end analysis, costing and definition. In 1991, DND was faced with the need to reduce the Canadian Forces from 84,000 to 76,000 by March 1995. Its original plan was to accomplish these reductions initially by means of natural attrition, reduced recruiting and the application of existing personnel policies such as the release of personnel at the end of their period of employment. Incentive packages were to be used as a last resort if the other mechanisms were insufficient to accomplish the necessary cuts. However, in late 1991 the Department decided to focus more on offering incentives to accomplish its reductions.

2.35 The decision to focus on incentive payments was based, in part, on the need to reduce personnel in specific military occupations and on DND's perception that it had a moral obligation to afford military staff the same benefits as civilian personnel, who had recently been given employment security as a result of the 1991 changes in the Work Force Adjustment Directive.

2.36 We could find no evidence that the incentive payments option was adequately costed and compared with the costs of alternative downsizing strategies. Our analysis, and that undertaken by DND's Internal Audit, indicated that even with reduced attrition, the targeted reductions for the first three years of the program could have been achieved

In DND, the management of reduction initiatives was clearly complicated by continually increasing reduction targets.

Minimizing the cost of using departure incentives was not an initial priority.

The late introduction of the payback and subsequent changes to the original payback formula did not reinforce departmental accountability for cost effectiveness.

without the 3,600 incentive packages. However, DND has indicated that without the use of incentives, the resulting Forces would not have consisted of the military trades and occupations necessary for operations. Subsequent government decisions in the 1994 and 1995 Budgets to reduce the Canadian Forces to 60,000 by March 1999 resulted in cuts significantly larger than natural attrition and other traditional methods could accomplish.

2.37 The RCMP believed that it would require departure incentive packages for uniformed and civilian members involuntarily laid off as a result of expenditure reductions. Throughout the development of the incentive package, the RCMP consulted the Treasury Board Secretariat, which recommended that the Force benchmark the size of proposed entitlements to other federal government incentive plans.

2.38 Although the RCMP's decision was based on the rationale that involuntary employee departures would occur as a result of reductions, there was limited analysis to determine the extent to which departure incentives would be required. The RCMP analyzed its traditional tools available to effect reductions but did not prepare a comprehensive needs analysis showing to what extent each of these tools — attrition, recruitment, redeployment, and *RCMP Superannuation Act* provisions to waive early retirement pension penalties — could be used to meet reduction requirements.

Minimizing the cost of using departure incentive programs was not a departmental priority

2.39 Minimizing the cost of using departure incentives was not an initial priority for the departments that we reviewed. A key reason for this appears to be that a portion of the incentive payments, particularly for those organizations deemed "most affected",

was in many instances paid not by the department but through central funding arrangements.

2.40 This is not a new issue. As noted in our 1992 Report chapter, Payments to Employees under the Work Force Adjustment Policy, "Managers made decisions regarding payments in lieu without concerns for cost effectiveness." The chapter asked whether managers would have reacted differently if they had known the full costs of their decisions, and if their own budgets had had to absorb them. Although we have observed more cost awareness than in 1992, the same question is still relevant today. At the start of Program Review, departments focussed primarily on reviewing their programs, identifying areas for reduction, reducing expenditures, meeting reduction targets on time and maintaining fairness and equity in identifying those who would receive departure incentives, not on the costs of those incentives.

The issue of "payback" was not well communicated or always well understood

2.41 As indicated in Chapter 1, Treasury Board Secretariat established a test for cost effectiveness called "payback" to ensure that employee departure incentive costs would not be higher than the reduction in salary and wages. In December 1995, Treasury Board Secretariat indicated that, as a guideline, each department should recover its departure costs from a reduction in their salary, wage and benefits costs over a period of three years ending 31 March, 1998. Following Program Review II, the period of calculation was extended one year.

2.42 The late introduction of the payback test in December 1995 and subsequent changes to the original payback formula did not reinforce departmental accountability for cost effectiveness. For instance, in December 1995, Treasury Board Secretariat

estimated the cost of a pension waiver to be \$100,000. By that date, 64 percent of all employee departure incentives involving a pension waiver had already been approved for affected employees. A year later, the actuarial estimate increased to \$125,000.

2.43 As a result, some departments did not manage rigorously the mix of the various departure incentives and the level of natural attrition. As departments were asked to provide only their reasons for exceeding the payback objective, there was little incentive for them to be concerned about accountability in this area. Departmental managers we interviewed indicated that they continued to have difficulty understanding the concept of payback and their accountability for it.

Volunteering for departure incentives was an accepted departmental practice

2.44 Once work force reduction has been decided on as a means to effect expenditure reduction, public and private organizations follow a number of different approaches. They may:

- call for volunteers and decide which positions to reduce on the basis of employee responses;
- cut specific positions that are considered non-essential to future requirements; or
- use a mixed approach, identifying both surplus positions and employees who wish to leave (volunteers) and then, as a first step, eliminating the positions where there is a match.

2.45 Each of these approaches has advantages and disadvantages. The exclusive use of voluntarism may be seen as the most humane and quickest method to effect reduction, because the people who go are those who want to leave. However, there are numerous disadvantages to using this technique

alone. It can create false expectations among employees; there may be a mismatch between those volunteering to leave and the unit or job cuts required; or the organization may lose the best performers, who usually have the least difficulty finding suitable employment elsewhere.

2.46 **Voluntarism was used for a variety of reasons.** Work force reduction was primarily an involuntary program; that is, its fundamental purpose was to provide departure incentives to employees affected by expenditure reduction. We expected that departments who decided to cut positions and staff would normally identify surplus jobs, grant a departure incentive to the incumbents and then abolish those positions. In situations where a number of similar jobs were affected, departments would consider the use of the mixed approach, matching surplus positions to employees volunteering.

2.47 Some departments we examined (DND, HRDC, NRCan) provided incentives to volunteers. In some cases, the practice was formalized within the organization. In some it was deployed as part of a mixed approach. In others, we identified individual examples of this practice, particularly in executive work force reduction. Several factors have contributed to its use:

- the attractiveness of the financial incentive package offered to employees;
- the additional 15 weeks' cash payment incentive offered by Treasury Board to employees who left before 15 July 1995;
- the use of a system of alternates ("swapping") that allows people who want to leave to swap jobs with people who want to stay;
- the short time frame in which departments had to make reduction decisions;

Work force reduction was primarily an involuntary program.

We found instances where management did not first identify surplus positions but rather focussed first on employee wishes.

- the magnitude of the work force reductions required in some departments; and
- the prevailing government objective to ensure peace in the workplace while effecting significant reductions.

2.48 In some departments, we found instances where management did not first identify surplus positions but rather focussed first on employee wishes. For instance, CIDA switched some of its staff who wanted to leave from essential to non-essential positions, which it declared surplus. Those employees were granted departure incentives.

2.49 HRDC approved the departures of the majority of employees who volunteered to leave. At the outset, the focus was on employees, not on positions. The most difficult task for managers was to deny requests for early departures. Our field visit to regional and local offices revealed that there was confusion about work force reduction targets, perceived by managers as “moving targets”. In the end, about 600 more departure incentives were given to employees than were required to meet the reduction requirements.

2.50 We estimate the cost of the additional 600 departure incentives to be approximately \$50 million. Normally, the wage and salary savings from employee reductions are used to recover the cost of departmental incentives. In this case, HRDC used the savings from these extra cuts (estimated at \$23 million) to fund other operational requirements, such as the hiring of additional term employees. From April 1995 to December 1997, the number of term employees increased by 625.

2.51 Some employees who volunteered and were approved for departure had experience and skills that these departments would later require. For instance, in DND, reductions in 1992 and 1993 resulted in shortages in six army combat trades and in vehicle technicians.

Increased peacekeeping commitments, as well as inadequate control over the number of applications accepted, contributed to these shortages. A decision in 1995 to approve 1,500 more applications than were required helped to achieve the overall reduction target but resulted in shortages of pilots, naval signalmen, naval radio operators and military police.

Implementation

2.52 Once they have decided to undertake work force reductions, most organizations create a special structure, project team or committee to plan and co-ordinate implementation. Staff of these structures need to be free from operational distractions so they can focus their efforts on the reduction. They are usually under the direction of a senior manager and include personnel from line operations and corporate policy and planning functions.

2.53 In most departments that we reviewed, headquarters set corporate priorities and criteria. Guided by those criteria, sector or field organizations prepared proposals that were reviewed by key stakeholders at headquarters and then reviewed and approved by senior management. Branch and field-level managers implemented the proposals. Several of the departments maintained central implementation teams to facilitate and co-ordinate progress across the department.

2.54 We found that departments generally used existing staff functions in areas such as finance and personnel to co-ordinate and control individual transactions, and to ensure compliance with targets as well as the Treasury Board's Work Force Adjustment Directive. In many organizations, union-management working groups were established to deal with issues stemming from work force reduction initiatives.

2.55 To augment the work of their central teams, decentralized organizations

used networks of regional committees. Many of the organizations experienced some initial difficulty acquiring and co-ordinating the necessary financial and human resource information to support work force reduction. As the reduction progressed, however, departments reported improved information systems and reporting.

Communications

2.56 In the climate of uncertainty surrounding any expenditure or work force reduction, it is essential to establish clear and effective lines of communication. A two-way communications strategy is needed to provide employees with accurate and timely information and to receive feedback, questions and concerns.

2.57 Employees need information on the objectives being pursued; management's strategies; how many and in what way employees will be affected; planned arrangements for consultation with employees and their unions; guidelines and procedures that will be followed; and the overall timetable of activities. Employees also need an opportunity to ask questions, contribute ideas and provide frank and open comment.

Communications with employees were well managed

2.58 Departments used a wide variety of communication techniques to ensure that employees were made aware of what was being done, why it was being done and the specific details of various departure initiatives being offered. Employees were given a variety of ways to provide feedback and receive answers to their questions. These included question-and-answer sessions, and fax or telephone numbers that employees could use to receive personalized counselling or responses to their queries.

2.59 Departments used videos, special bulletins and existing newsletters and

magazines to ensure that all staff received a consistent message as quickly as possible. Where individual employees had been identified for potential departure, they often received an individualized package of information and met privately with managers and other specialists.

2.60 In most organizations, senior management visited major centres to deliver the message and respond to questions and concerns, in some cases assisted by union personnel. Some departments ran workshops, focus groups and briefing sessions to both give information and receive feedback.

Treating Employees in a Humane and Sensitive Manner

2.61 Work force reduction has a significant impact on those who leave the organization and those who remain. It is essential that senior management endeavour to minimize the negative effects of downsizing on both groups. It is important that management show genuine concern and understanding for those leaving and provide appropriate transition assistance.

2.62 Management and staff who remain need to understand fully how work force reduction will impact on the organization, how the organization will now function and how their work will change. There is a need to pay particular attention to determining how the organization will adapt to the reduced work force; what changes will be made in the operational processes or work design; what the resulting impact will be on the workload of employees; and their capacity to carry out their responsibilities.

Employees were treated humanely and with sensitivity

2.63 The departments we examined provided good examples of humane and sensitive treatment of employees, particularly those who were departing. Some examples include the use of

Departments used a wide variety of communication techniques to both provide and receive information.

Management showed genuine concern and understanding for those leaving.

Selected departments generally complied with Treasury Board policies and guidelines.

alternates (“swapping”); virtually no involuntary layoffs (RCMP); a departmental policy emphasizing employee needs and interests as a factor in identifying surplus jobs (HRDC); seminars for managers, dealing with the impact on affected employees; training for employees in stress reduction; and transition workshops and job fairs for those leaving (NRCan).

2.64 We found that given the magnitude of the change required and the short time frame allowed, departments generally placed less emphasis on the needs of employees who would remain, particularly during the period of work force reduction. Managers and staff we interviewed in DND indicated that more support had been afforded to those departing than to those staying. Increased workload has emerged as a common concern of many employees who remain in that Department and in others that we reviewed.

2.65 However, some departments did focus on employees who remained. For example, Environment Canada and Statistics Canada used climate surveys or environmental scans to identify staff concerns and elicit employee input and ideas. HRDC created career centres for both departing and remaining employees. In addition, it conducted a number of studies and surveys. NRCan conducted special seminars for employees who remained.

Monitoring and Measuring Progress

General compliance with Treasury Board rules for departure incentive programs

2.66 Monitoring, reviewing and evaluating results achieved is an important ingredient of effective expenditure and work force reduction. Monitoring and evaluation mechanisms are needed to ensure that the change initiative is

progressing as planned, the desired results are achieved in a timely and cost-effective way and there is compliance with approved policies and guidelines.

2.67 The Treasury Board Secretariat provided guidelines to departments and a management and accountability framework for departure incentive programs. All departments were expected to be accountable for fulfilling their responsibilities. A series of measures and tools were developed to promote sound management of the programs.

2.68 We examined the extent to which the seven selected departments complied with both the spirit and intent of applicable Treasury Board policies and procedures. We reviewed reports of departmental midterm audits, DND internal audits and Treasury Board-directed audits that covered all departure incentive programs. We reviewed the compliance work of internal audit and, after applying our standards for reliance, came to the conclusion that we could rely on the results.

2.69 A key expectation was that departments would conduct midterm audits of their departure incentive programs. We found that six of the seven departments we reviewed had done so. Statistics Canada did not conduct a midterm audit due to the low number of employee departure incentives granted.

2.70 Our review indicated that the selected departments generally complied with Treasury Board policies and guidelines covering departure incentive programs. However, we noted some deficiencies and areas for improvement, including compliance with rules for executive cash-out programs and controls for monitoring returning employees.

2.71 Since 1992, DND’s Internal Audit Division has undertaken comprehensive audits of the Department’s human resources management. Among other things, these audits have covered contracting for personnel services,

management information systems, military pay and civilian overtime. Internal Audit also conducted a thorough examination of both the military and civilian reduction programs.

2.72 These audits have been crucial to the improvements we observed at DND. Management has recognized the fairness and accuracy of the audits and has responded to the recommendations. Among the appropriate corrective measures undertaken, DND has issued and disseminated a Lessons Learned Report, issued guidelines and monitored post-employment contracts for personnel services, refined eligibility criteria for departure incentives and regularly issued status reports to central agencies and the Department's senior management.

Executive departure programs were generally well managed

2.73 We reviewed the Treasury Board-directed audits of the Executive Employment Transition Policy (EETP) covering five of the selected departments (CIDA, DND, HRDC, Environment, NRCan). Initial concerns about staffing in the Executive category triggered the audits, which examined 74 departure incentives provided to executives between 1 April and 31 December 1995. These audit reports indicated that executive departure programs had been generally well managed. Most paid executive departures had followed the rules; however, the audit reports did note some questionable cases. Six executives received departure incentives after they had been shifted to special assignments, without a corresponding reduction in the established number of executive positions. Three executives received incentive packages while on leave without pay.

Some recipients of departure incentives are returning

2.74 The Treasury Board Secretariat guide on the Public Service Post-

Employment Regime, issued on 31 July 1995, outlines the terms, limitations and conditions for those who have received departure incentive packages and later wish to return to the public service as employees or on contract.

2.75 Recipients of departure incentives returning as employees. As indicated in Chapter 1, employees can be rehired or reappointed to positions in the public service, DND and the RCMP. Since July 1995, employees in all organizations returning within the period for which they have received a departure incentive must return, on a pro rata basis, the incentive payment they received. Prior to July 1995, all departments except DND (military) were subject to rules requiring that rehired or reappointed employees repay their departure incentives. Before December 1995, RCMP members were required to repay the remaining value of their incentive payment only if they were re-engaged as a uniformed member. As a general rule, the government does not expect that many former public servants who received departure incentives will return to the public service.

2.76 We noted that between February 1992 and March 1997, about 600 employees who had received a departure incentive were rehired across all departments, DND and the RCMP. The majority (486) were from DND. Of these, 274 were military members who returned to DND as civilians and 73 who returned as military members.

2.77 About 130 of the 600 employees returned within the period covered by the requirement to repay on a pro rata basis the incentive they had received. Most of these rehires (110) were former DND employees. Of these, 75 had returned before Treasury Board established, in July 1995, terms and conditions for the repayment of incentives. National Defence informed us that there was no legal requirement for these employees to repay their incentive payments. This illustrates the importance of having

Weaknesses in the systems and processes for contracting and post-employment were identified.

guidelines in place to deal with such situations.

2.78 Of the remainder who returned after 1995, four came back to DND and repaid the appropriate portion of their incentives. In all cases that we examined, the applicable rules were followed. However, we do not know whether the remaining 25 employees rehired in other departments have repaid their incentives as required.

2.79 Recipients of departure incentives returning as contractors. We were also concerned about non-compliance in contracting with recipients of departure incentives. Under the Public Service Post-Employment Regime, former employees are permitted to earn only up to \$5,000 during the “window period” (the number of weeks covered by the cash payment they received) for personal services contracts immediately after employment.

2.80 We could not determine the extent to which recipients of departure incentives were returning on contract during the “window period”. Unless controls were set up to monitor returning employees, this was difficult to track because an individual could return undetected to the same department or another federal department as an associate or employee of a consulting firm.

2.81 National Defence, for example, concerned that military recipients of departure incentives might have returned to the Department on contract, conducted an internal audit. Although there was no specific tracking system for this purpose, an internal audit analysis was performed to identify departure incentive recipients returning as consultants. Over the two-year period under review, 150 recipients were found to have returned as consultants. However, based on a limited review of a sample of these contracting situations, DND Internal Audit indicated that there was no reason to suggest that

the rules concerning post employment or conflict of interest had been contravened.

2.82 Weaknesses in the systems and processes for contracting and post-employment were also identified in departments’ midterm internal audit reports. They included a lack of co-ordination between the contracting and human resources divisions and between headquarters and regions to determine whether cashed-out employees were subsequently rehired under contract (DND military, RCMP); and a lack of regular review and monitoring of contracting with former public servants (DND civilian and RCMP).

Results

2.83 We reviewed departmental results of reduction from four perspectives: expenditure and salary and wage trends during the reduction period; departmental work force reduction and the number of employee departure incentives provided; the cost of departure incentives; and the extent to which departments are meeting their reduction targets.

Most departments reduced their expenditure levels

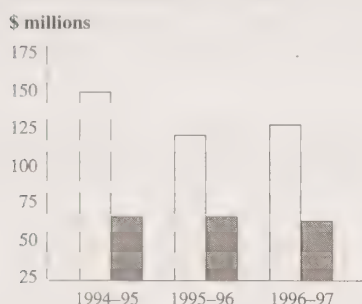
2.84 Exhibit 2.4 outlines actual expenditure trends from 1993–94 to 1996–97 for the sample departments and the government as a whole. Each departmental chart shows net expenditures (excluding transfer payments and public debt charges) and gross salary and wage expenditure trends.

2.85 Net departmental expenditures have been reduced in three of the departments we examined (Environment, DND and NRCan). In others they have either risen (Statistics Canada) or both risen and decreased (RCMP, CIDA, HRDC).

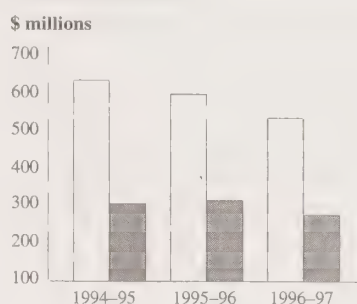
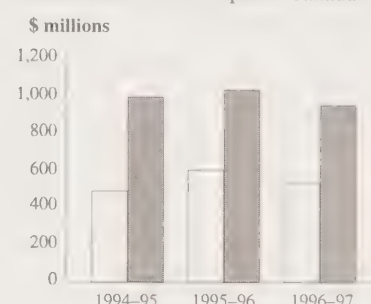
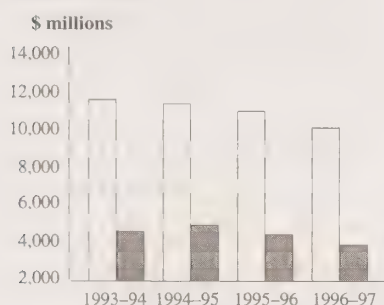
2.86 In the same period, salary and wage expenditures followed a different pattern. In five departments their level

Exhibit 2.4

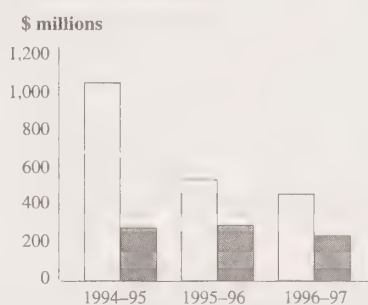
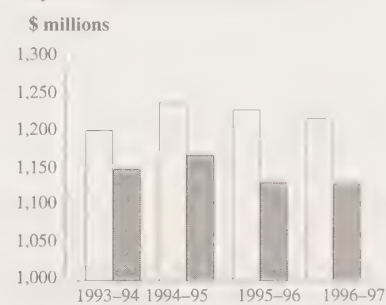
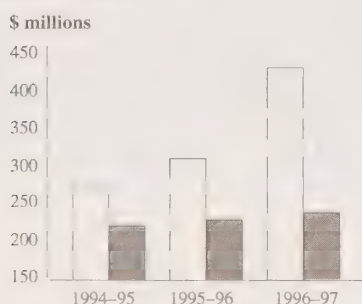
Expenditure and Salary & Wage Trends for the Government and Sample Departments (1993–94 to 1996–97)

Canadian International Development Agency¹

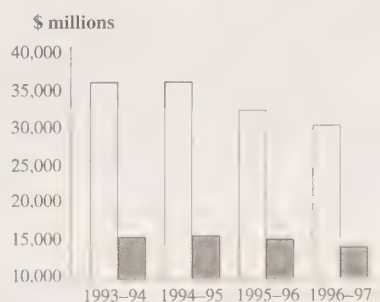
Environment Canada

Human Resources Development Canada²National Defence³

Natural Resources Canada

Royal Canadian Mounted Police³Statistics Canada⁴

Government of Canada



□ Expenditures⁵
 ■ Salary & Wage Envelope⁶

¹ CIDA – The Agency states that expenditures include debt forgiveness amounts of \$37 million (1994–95), \$12 million (1995–96) and \$20 million (1996–97).

² HRDC – Its net expenditures appear on the chart as lower than salaries and wages. This is due to significant amounts of revenue credited to its appropriations. For example, in 1996–97, its gross expenditures were \$1,956 million and its revenue was \$1,414 million, resulting in net expenditures of \$542 million. This was lower than its 1996–97 salaries and wages of \$963 million.

³ DND and RCMP – 1993–94 data are shown because these organizations began using departure incentives earlier than the rest of the departments.

⁴ Statistics Canada – The agency states that increased expenditures are due mainly to the 1996 census (\$47 million in 1995–96 and \$152 million in 1996–97).

⁵ Expenditures – Expenditures are reported net of revenue credited to appropriations. We have excluded Transfer Payment and Public Debt Charges.

⁶ Salary and Wage Envelope (SWE) – It is a component of personnel costs and does not include certain types of allowances such as those used to compensate employees for certain expenses, specific duties, or work in isolated locations. In addition, the SWE does not include the employer contributions to various pension and benefit plans.

Source: Public Accounts of Canada and Public Works and Government Services Canada Public Accounts data base

The number of indeterminate employees in five of the seven departments decreased.

rose initially and then fell. Government of Canada net expenditures and salary and wage trends tended to fall after fiscal 1994–95.

Departmental work forces are being reduced

2.87 We also examined departmental changes in the number of indeterminate employees, from before reductions until 31 March 1997. Exhibit 2.5 outlines the trend in each of the sample departments as well as the number of departure incentive packages provided to employees during the same period.

2.88 We found that the number of indeterminate employees in five of the seven departments decreased over the

reduction period. Only CIDA and Statistics Canada increased their number of indeterminate employees. In most departments, the number of departure incentives provided to employees exceeded the reduction in the number of indeterminate employees, for such reasons as:

- employees transferred into the department during Program Review (CIDA);
- newly funded initiatives that required additional human resources (Statistics Canada, RCMP);
- the civilianization/reclassification of uniformed positions and replacement of the uniformed incumbents, who departed with an incentive (RCMP); and

Exhibit 2.5

Net Changes in Numbers of Indeterminate Employees and Departure Incentive Packages from the Base Year to 31 March 1997

Department ¹	Number of indeterminate employees (base year)	Number of indeterminate employees (31 March 1997)	Decrease (increase) in the number of indeterminate employees	Number of departure incentives provided to employees	Difference between the change in the number of indeterminate employees and the number of departure incentives
DND	117,682	81,023	36,659	22,256	14,403
HRDC	22,639	18,399	4,240	4,439	-199
NRCan	4,599	3,516	1,083	1,076	7
ENV	5,004	4,239	765	811	-46
RCMP	21,122	20,675	447	971	-524
CIDA	1,207	1,208 ⁽²⁾	(1)	83	-84
StatsCan	4,511	4,533	(22)	6	-28

Notes:

¹ Base year: 1991–92 for the Department of National Defence, 1992–93 for the Royal Canadian Mounted Police and 1994–95 for the other departments.

² The number of CIDA indeterminate employees of 31 March 1997 includes 58 indeterminate employees who transferred from the Central and Eastern European Program of the Department of Foreign Affairs and International Trade to CIDA in 1995–96.

Source: Quantitative information concerning indeterminate employees obtained either from respective departments (DND, RCMP, CIDA, StatsCan) or from Treasury Board Secretariat (HRDC, NRCan, ENV). Departure incentive information obtained from departments. With the exception of DND, we did not audit the information provided.

- an increase in municipal and provincial contract policing positions by contracting partners (RCMP).

2.89 In DND, however, the reduction in the number of indeterminate employees far exceeded the number of incentive packages provided.

2.90 Exhibit 2.6 summarizes some incremental departure incentive costs to 31 March 1997. The costs of departure incentives varied significantly among the departments selected. The differences can be explained by such factors as the number and type of departure incentives provided by departments, the level of the natural attrition used during reductions, and the profile of departing employees (for example, lower-paid compared with higher-paid employees).

Departments are meeting their reduction targets

2.91 The departments we reviewed met their 1995–96 and 1996–97

expenditure reduction targets. We expect that most of them will be able to meet their reduction targets in each of the remaining two years of Program Review if the government continues its commitment to expenditure reduction targets.

2.92 As indicated in Chapter 1, a key reason for this is that expenditure reductions resulting from Program Review are taken out of departmental budgets at the outset of each fiscal year. In addition, we examined the extent to which departments spent within the budgetary levels prescribed by Treasury Board for these years.

2.93 We reviewed the overall funds available for use (spending authority) for each of the seven departments, and their net actual expenditures, for 1995–96 and 1996–97. “Funds available for use” incorporates all changes in funds available to departments, including budget reductions and moneys for new initiatives. We found that from an expenditure reduction perspective, departments spent

The departments we reviewed met their 1995–96 and 1996–97 expenditure reduction targets.

Exhibit 2.6

Incremental Costs of Departure Incentives from the Base Year to 31 March 1997

Department ¹	Cash Incentive Payments ² (\$ millions)	Estimated Pension Waiver Cost for the Early Retirement Incentive Program (\$ millions)	Total Departure Cost (\$ millions)	Number of Departure Incentives
DND	799	78	877	22,256
HRDC	143	247	390	4,439
NRCan	48	49	97	1,076
ENV	35	47	82	811
RCMP	44	3	47	971
CIDA	3	7	10	83
StatsCan	0.2	0.4	0.6	6

Notes

¹ Base year: 1995–96 for all departments except DND (1991–92) and RCMP (1994–95)

² Cash incentive payments consist of those benefits outlined in Chapter 1, Appendix A. Cash incentive payments do not include severance pay paid at the layoff rate.

Source: Quantitative information obtained from the respective departments

within their funding limits over this two-year period.

Impacts

2.94 Fundamental change involves risk: risk that the timing will be wrong, risk that what is planned or required will not occur, risk that unwanted consequences will result, or risk that in the long term, the situation will be worse than the current status quo. Program Review and other changes that were occurring across departments presented such risks. As previously noted, planned targets for departmental expenditure reductions — the primary goal of the Program Review exercise — are being met. In addition, Program Review provided a collective opportunity to change the focus of government and the way it functions.

2.95 Our findings were based on departmental studies, departmental midterm audit reports, and interviews with managers, employees and union representatives. Because Program Review and other departmental change initiatives are still under way, any assessment of the impact of work force reduction must be considered preliminary. However, our audit work provides some immediate insights.

Vital operations were maintained in least affected departments

2.96 Of our seven departments, RCMP, CIDA and Statistics Canada were among the least affected organizations. We found that they possessed both the means and the interest to ensure that vital core operations and activities were not impeded by work force reduction requirements.

2.97 As of March 1997, the majority of the RCMP's work force reductions under Program Review I were in administrative functions. Reductions were also made in airport policing and other peripheral activities, while protecting core policing operations. In addition, the

RCMP used other techniques to effect savings in operating expenditures, such as civilianizing positions previously classified as regular uniformed RCMP members. Its Program Review II reductions are being met by eliminating federal funding for policing at Canada's nine international airports. The RCMP is withdrawing from four airports and recovering its costs at the remaining five. Other reductions will be met through other initiatives, including cost recovery.

2.98 Statistics Canada maintained a no-layoff policy, instead achieving required expenditure reductions by reducing or eliminating specific survey activities and reassigning the employees involved or by redesigning automated survey methods. CIDA made cuts both to its aid disbursements abroad and to its operating and salary and wage budgets, the latter representing the smaller cuts.

2.99 Before Program Review, both CIDA and the RCMP had fundamentally changed the way they were organized and operated. These long-term initiatives remained a departmental priority even as Program Review cuts were announced. In effect, Program Review requirements accelerated the implementation of existing departmental change initiatives.

Some operational impacts were noted

2.100 Staff we interviewed in NRCan, HRDC, Environment Canada and DND identified some significant operational impacts as a result of Program Review reductions. For example, the rate at which Environment Canada's Weather Service accelerated its planned automation and the consolidation of a number of its weather offices reduced its ability to meet certain World Meteorological Organization guidelines.

2.101 Some scientists in NRCan indicated that as a result of reductions, they no longer have the funds and technical staff they need. Others worried that the loss of some key senior scientists may negatively affect their organization's

There were some significant operational impacts as a result of Program Review reductions.

reputation and, as a result, its ability to attract needed funding.

2.102 While HRDC has reported some improvement in its overall level of productivity, there have been some indications of operational problems as a result of work force reduction. The departure of experienced employees and the closing of several offices have, to some extent, affected the level of personalized service to clients. Some managers informed us that office closures have, in some instances, increased clients' waiting time for personalized service.

2.103 National Defence also experienced a change in the Canadian Forces' ability to operate at normal capacity after large reductions in strength and unforeseen peacekeeping demands, which led to some undermanning of key military occupational groups. Internal audit reports indicated that the first two years of reductions in DND caused some shortages in six army combat trades and in vehicle technicians. Similar problems occurred in 1995 with pilots, naval signalmen, naval radio operators and military police. As a result, some additional recruiting was required.

2.104 Expenditure reductions have left many departments with less funds and fewer staff to meet new and changing priorities. The financial flexibility they had in the past to meet these challenges has been greatly diminished. Departments are engaged more than ever in making choices among programs and projects they can no longer fund, practices and processes they can no longer follow, and services they will have to provide either differently or not at all.

2.105 NRCan provides an example of the impact of lost financial flexibility. During 1997, the Department reprofiled its budget allocations to accommodate re-engineering and other initiatives, leading to further downsizing. Unions strongly objected and employee reaction

was negative, although departure incentives were still available.

Departments understand their programs and operations better

2.106 Most of the departments we reviewed indicated that Program Review has made it possible for their managers to better understand their programs, operations and activities, how they function and what they contribute. As a result, in many instances these departments have taken the first step toward better handling of the Expenditure Management System, business planning and performance reporting.

Human resource impacts of work force reduction

2.107 We identified some preliminary human resource issues as a result of our audit work in the seven departments and our review of midterm audit reports of 30 other departments. In summary, we found:

- low employee morale;
- lower levels of employee trust in their management and loyalty to their organizations;
- the loss of needed employee skills and experience;
- increased workload per employee; and
- higher levels of employee uncertainty about the future direction of the public service and their departments.

2.108 Some managers and employees in NRCan, Environment Canada and HRDC identified an overall increase in workload per employee. Shortages of skilled and experienced employees were identified in DND, HRDC, Environment Canada and NRCan. Employee uncertainty about their future and that of their organizations has increased in some departments, due in part to shifting reduction targets. While all of these factors impact adversely on employee morale, the effects of

Shortages of skilled and experienced employees were identified.

Employee uncertainty about their future and that of their organizations has increased.

continuing circumstances such as fiscal restraint and salary freezes before and during this period cannot be discounted.

2.109 However, we also received positive comments on the human resource impact of work force reduction. Employees and union representatives in some departments praised management's handling of reductions. Very few grievances were filed in the seven organizations. Managers also noted that work force reduction and financial incentives have created an opportunity to renew and restructure the work force by releasing employees considered unsuitable for future responsibilities in the changed departmental structure.

Work force age distribution has changed in departments

2.110 We examined the age distribution of the seven departments both before work force reduction and as of 31 March 1997. We found that departmental work forces have generally become more middle-aged. In 1997 there were proportionally fewer employees below age 40 than five years ago. For example, DND's under-40 civilian work force has decreased since 1992 by about seven percent, while the number of employees between 40 and 50 has increased by 15 percent. This change is consistent with the fact that about one in three departures was by an employee either younger than 40 years or 60 and older.

Some departmental occupational groups have been significantly reduced

2.111 Our review of selected departments reveals that some occupational groups have been significantly affected by work force reductions from March 1995 to March 1997.

- The Administrative Services Group was reduced by 22 and 19 percent in HRDC and NRCan respectively.

- The Clerical and Regulatory Group decreased by 31 and 22 percent in NRCan and HRDC.

- The Secretarial Group was reduced by 44, 40, 29 and 21 percent respectively in HRDC, NRCan, RCMP (public servants) and Environment.

- DND civilian administrative support and operational groups were reduced by about 30 percent.

2.112 We also noted that the Executive group at NRCan has been reduced by 29 percent since 1995. Since 1992, the upper rank levels in DND (lieutenant colonel and above) have decreased by 24 percent. Our review of Treasury Board Secretariat data concerning Natural Resources Canada and Environment Canada, two major science-based departments, reveals that since 1994 the number of indeterminate employees in their science and technology groups has been reduced by about 23 percent. The total impact will not be known until the end of Program Review in 1998–99.

Conclusion

Lessons Learned and Recommendations

Reduction initiatives need effective management

2.113 Our review of departmental leadership as well as planning and implementation practices confirmed that expenditure and work force reductions require effective management. We found leadership and strong senior management involvement in the seven departments selected. Any change process of the magnitude of Program Review requires continuing political commitment and leadership at the top to ensure that goals are met and direction is maintained.

Readiness for change is an advantage

2.114 The management of change is now, more than ever, an integral part of

Departmental work forces have generally become more middle-aged.

ensuring survival in both the public and private sectors. The operating cultures of many organizations are shifting to embrace change as a prerequisite to continued organizational viability. Departments that we examined are also undergoing this change in management culture and recognizing the need for ongoing mechanisms to deal with it.

2.115 Strategic planning was an important mechanism for managing departmental reduction effectively. Departments that had already been rethinking their operations and organizational structures were better able to make effective use of the limited time available to plan for expenditure reductions. They were also able to integrate their reduction initiatives with their re-engineering efforts.

2.116 Some of our sample departments were already engaged in advanced planning and preparation at the outset of Program Review. Statistics Canada provided a good illustration of ongoing structural readiness for change as it had altered its planning, operating and monitoring infrastructure in order to cope with the degree of continuing change it anticipated.

2.117 In our view, Program Review gave most departments enough time (three years) to carry out each phase of required reductions, a feature that increased departmental planning options and allowed for a longer-term approach and a more orderly transition process.

More emphasis on costs is needed

2.118 Departmental priorities have clearly been focussed on meeting reduction targets in a humane and timely manner, while placing less emphasis on cost management. The lack of emphasis on cost management, coupled with the number and value of departure incentives offered to employees, contributed to

higher than expected costs of reduction in some departments.

2.119 In our view, the Treasury Board Secretariat could have done more to ensure that departments were fully accountable for their use of costly employee departure incentive packages. While the concept of “payback” was sound, there were several concerns about the way it was designed, applied and calculated at the departmental level. We have found some improvement since our 1992 audit, but departments continue to put limited emphasis on the costs associated with reducing their work forces.

2.120 In future, Treasury Board Secretariat needs to work more closely with departments to ensure that they strike an appropriate balance between meeting reduction targets in a humane and timely manner and managing the costs of reduction programs.

2.121 At the end of Program Review, Treasury Board Secretariat should work with departments to determine final work force reduction costs and final reductions in salary and wage expenditures. Treasury Board Secretariat should ensure that Parliament is fully informed.

Treasury Board Secretariat's response:
Departments are reporting work force reduction costs and expenditure reductions to us on an ongoing basis. We accept that we will report, comprehensively, at the end of Program Review, scheduled for March 1999.

2.122 Good management relies on timely, accurate information. Reduction initiatives are not alone in their need to be supported by information. Any complex decision-making process must have access to sound data. We found that departments had some initial problems identifying and providing the necessary financial and human resource information. Departments that were already changing or reducing

Departmental priorities have clearly been focussed on meeting reduction targets in a humane and timely manner, while placing less emphasis on cost management.

Management now needs to focus on the employees remaining after the reductions have taken place.

their organizations when Program Review began had ready access to relevant management information that supported them in handling requirements for reduction. Others had to build this capability over time.

2.123 As an important first step in any future change initiative of this magnitude, departments should ensure that they have the necessary financial and human resource information available on an ongoing basis.

Treasury Board Secretariat's response: The Treasury Board Secretariat will continue to ensure that financial and human resource information systems are adequate to meet management and reporting requirements. In co-operation with departments, we will make required improvements and departments will be given greater access to integrated data bases developed at the Treasury Board Secretariat.

Need for a sustainable and adaptable work force to meet future challenges

2.124 In light of ongoing reduction activities as well as other departmental changes, it is essential that departments continue their efforts to identify and assess the impact of recent reductions on the composition and capability of their work forces. The loss of both younger and older employees presents specific challenges for the future. Some key aspects to examine would include the change in overall levels of employee experience and competency, vulnerability to future losses arising from attrition and retirement, and the need for different and accelerated recruitment strategies.

2.125 In 1997, the Privy Council Office launched a public-service-wide program called *La Relève*. Its purpose is not only to address long-standing human resource issues but also to deal with the consequences of work force reductions under Program Review. Its ultimate goal is

to revitalize the federal public service as an institution.

2.126 Departments should continue to examine the impact of expenditure reductions on the composition and competency profile of their current work forces and prepare plans to meet identified future challenges.

Treasury Board Secretariat's response: *La Relève* has brought an enhanced awareness to the Human Resource Planning imperative and the need to support employees so they will continue to provide high-quality services to the Canadian taxpayers.

Need for priority in dealing with human resource impacts of reduction

2.127 Generally, the departments we examined were good examples of fair and sensitive treatment of departing employees. However, the remaining work force may be vulnerable. In her Fourth Annual Report to the Prime Minister on the Public Service of Canada (1997), the Clerk of the Privy Council speaks of a "quiet crisis under way in the public service today", fueled in part by the results of the recent work force reductions. Our audit findings on human resource impacts, particularly in the most affected departments, support that concern.

2.128 Management and employee concerns about the loss of experience and qualified employees, the perceived high level of workload per employee and uncertainty about future departmental direction best characterize the current mood in these departments.

2.129 Management now needs to focus on the employees remaining after the reductions have taken place. In general, this will require focussing on the remaining departmental work force from the perspective of changes in work processes, employee retraining and future workload and productivity requirements.



About the Audit

Objectives

- To determine the extent to which announced targets for expenditure reduction or, where specified, work force reduction have been or are likely to be achieved.
- To identify the cost of work force reductions and to determine the extent to which the initiatives resulted in savings.
- To assess the extent to which departure incentive programs were managed in accordance with relevant policies, directives or guidelines.
- To identify lessons learned for possible application in the future.

Scope

We examined expenditure and work force reduction efforts at both the central agency and departmental levels from the perspective of leadership, accountability, planning, implementation, cost, results and the impacts on departments and employees.

We reviewed the evolution of expenditure and work force reductions over the years, with an emphasis on the management and results of expenditure and work force reductions announced since 1995, in the context of Program Review. Our audit covered the departure incentive programs described in summary in Chapter 1, Appendix A, including the Work Force Adjustment Directive (WFAD), Force Reduction Programs (FRP), the Civilian Reduction Program (CRP), the Early Retirement Incentive (ERI), the Early Departure Incentive (EDI), the RCMP Work Force Adjustment and the Executive Employment Transition Policy (EETP). We also considered the results of work force reductions due to privatization and devolution.

In Chapter 1, we report on activities of central agencies, including the Department of Finance, the Treasury Board Secretariat, and the Privy Council Office in relation to expenditure and work force reductions. We examine issues such as central planning, direction and guidance, the management and accountability framework, and the achievement of overall results. The rationales for the expenditure reduction decisions themselves were excluded from the scope of our audit, as was the evaluation of the effects of work force reductions on individuals who had already left.

In Chapter 2, we review the implementation and management of expenditure and work force reductions in seven departments selected for detailed audit work. The departments were the Canadian International Development Agency, Environment Canada, Human Resources Development Canada, National Defence (military and civilian), Natural Resources Canada, the Royal Canadian Mounted Police (members and civilians), and Statistics Canada.

Criteria

The criteria used in this audit were drawn from Treasury Board Secretariat policies, directives and guidelines as well as best practices from public and private sector experience with expenditure and work force reductions.

We expected:

- goals, objectives and parameters of expenditure/work force reduction initiatives to be clear and consistent with government intent;
- appropriate rationales to be prepared in support of reduction decisions;
- roles, responsibilities and accountabilities to be clearly identified and communicated;
- central agency officials and senior departmental officials to clarify in a timely manner reduction initiative expectations and procedures;
- plans to be in place to ensure effective implementation of reductions at both the departmental and service-wide levels;
- appropriate mechanisms to be in place to monitor progress, and adjustments to be made where required;
- reductions to be made in accordance with the spirit and intent of relevant central agency and departmental policies and directives, including guidelines on ethics and conflict of interest;
- results to be periodically evaluated and reviewed, and corrective action taken where indicated;
- expenditure reductions, work force reductions and savings to be consistent with approved target expectations;
- impact of reductions to be identified; and
- results, including work force reductions, costs, savings and effects, to be reported to appropriate authorities.

Approach

We focussed our examination primarily on actual government and departmental expenditure and work force reductions covering the period from April 1995 to March 1997 and, to some extent, those estimated up to March 1998. In the case of the Department of National Defence, our audit work included the period from 1991 to 1997, to cover both the Force Reduction and the Civilian Reduction programs. Our audit of RCMP covered the period from April 1994 to March 1997. Where appropriate and to the extent possible, we have relied upon audit work conducted on behalf of central agencies and in departments that we examined.

We gained an understanding of the evolution and history of expenditure/work force reduction since its inception in the 1960s. We reviewed the best practices related to reduction initiatives in both the public and the private sectors in Canada, as well as in the United States, Australia and New Zealand.

Our audit work included interviews, reviews of documentation, and analysis of information contained in numerous information systems managed by the Treasury Board Secretariat, the Department of National Defence or Public Works and Government Services Canada. Where appropriate, we have also drawn from relevant audits or follow-up work performed by this Office.

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**Report of the
Auditor General
of Canada
to the House of Commons**

Chapter 3
National Defence – Equipping and Modernizing
the Canadian Forces

Chapter 4
National Defence – Buying Major Capital Equipment

April 1998

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Chapter 3

National Defence – Equipping and Modernizing
the Canadian Forces

Chapter 4

National Defence – Buying Major Capital Equipment



April 1998

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Cat. No. FA1-1998/1-4E
ISBN 0-662-26792-3

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Chapter 3

National Defence —

Equipping and Modernizing the
Canadian Forces

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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National Defence —

Equipping and Modernizing the Canadian Forces

Main Points

- 3.1** A modern, multi-purpose, combat-capable force able to “fight alongside the best, against the best” is necessary to fulfil Canada’s defence policy commitments, although the policy does not require the Canadian Forces to possess every component of military capability.
- 3.2** According to Department of National Defence officials, Canada’s White Paper commitments are defined by the defence capabilities of the Canadian Forces. We found many equipment deficiencies that limit capabilities.
- 3.3** If the status quo persists, the Department’s available capital funding may not be sufficient to equip and modernize the force that National Defence is currently planning. Officials told us that they expect to be able to increase the capital portion of the budget. Nevertheless, they anticipate that hard choices may have to be made.
- 3.4** Personnel, operations and maintenance costs are rising, which is further reducing the portion of the budget available for capital equipment.
- 3.5** We found that the Department does not have an adequate policy framework to direct the almost \$1.4 billion it spends each year on equipment modernization. It does not yet have in place fully developed operational scenarios to guide planners, or performance information that identifies gaps.
- 3.6** Some other countries — notably the United States and New Zealand — have taken the lead in the way their government budgeting and management systems actively manage defence policy and resources.

Introduction

A Multi-Purpose Force Is Required

3.7 In 1994, the federal government released its Defence White Paper to “guide the work of the Department and the Forces into the next century.” According to the White Paper, the Canadian Forces are to be multi-purpose and combat-capable, able to fight alongside the best, against the best. It recognizes that Canada cannot cover the entire military spectrum, but the Canadian Forces must be capable of defending Canada as well as defending North America in co-operation with the U.S. military, on land, at sea and in the air. They must also be able to contribute to international peace and security.

3.8 The army is to consist of three brigade groups, adequately equipped to carry out their tasks. The navy must provide two naval task groups for a fleet balanced between Canada’s two open-water oceans. The air force must maintain capabilities for domestic and international operations, including fighter

and transport aircraft, search and rescue, and maritime and tactical air support.

3.9 The 1994 defence policy announced cuts in most areas of defence. In response, the Department cut planned spending on equipment by \$15 billion over 15 years. Some equipment projects were eliminated, reduced or delayed. The government wants National Defence to extend the life of its equipment, where cost-effective and prudent, and to buy new equipment only if it is essential to maintaining core capabilities. Resources are to be transferred “to where they are most needed — mainly to land combat and combat support forces.”

3.10 In 1994, the Special Joint Committee of the Senate and the House of Commons on Canada’s Defence Policy recognized that “less money means less equipment or less capable equipment”. It warned, “Budget cuts mean that the Canadian Forces may not have the capability to undertake tasks which the government would like them to take on.”

3.11 The Committee concluded that the Canadian Forces could not make do with less. It said, “Our present [1994]

“The primary obligation of the Department of National Defence and the Canadian Forces is to protect the country and its citizens from challenges to their security.”

(1994 Defence White Paper)



Canada's forces must be multi-purpose and combat-capable, able to fight alongside the best against the best (see paragraph 3.7).



military forces are barely adequate.” In the Committee’s opinion, National Defence required a “significant refocussing of mission and reallocation of resources to do the job we are asking them to do today.”

3.12 The Committee called upon Parliament to play an increased role in defence issues. It saw the need for regular review of defence policy and budgetary and procurement issues, involving both the Senate and the House of Commons.

Funds for Equipment Modernization Are Declining

3.13 Re-equipping the Canadian Forces has been a priority in defence policy since the 1970s, but recent defence budget reductions have slowed the pace of equipment modernization. The defence policy of 1987 recognized that years of declining spending on new equipment were causing a significant gap in the military’s ability to meet its commitments. To fix this problem, the government announced in its policy that it would alter some commitments and begin a long period of “steady, predictable and honest funding”.

3.14 In the late 1980s, spending on equipment, adjusted for accounting changes to Research and Development and Ammunition, accounted for about 20 percent of the defence budget. The government saw that “even this funding is insufficient to overcome the bow wave built up since the 1960s.” Nevertheless, spending for equipment modernization has fallen to about 14 percent of the defence budget today (1998–99), which is lower than the historical targets set to ensure that modernization continues for the Canadian Forces.

3.15 In 1996, following a series of budget reductions, the Department made a commitment to avoid repeating the experience of the early 1970s when “rust-out” became a serious problem.

Rust-out refers to deterioration in the condition of equipment that develops as old or obsolete equipment is not replaced. Although the Department did not expect reductions to affect the Canadian Forces’ ability to fulfil its tasks and missions, it recognized that a higher level of spending on equipment would be needed over the longer term. Despite this commitment, Long-Term Capital Plans and the Defence Services Program currently forecast a decline in equipment spending over the next five to 15 years.

Concerns Raised in Our Previous Audits

3.16 Since 1984, we have been reporting our concerns about spending for equipment modernization. We have commented on the Department’s inability to set priorities, develop adequate cost information or ensure that equipment plans were affordable.

3.17 In 1984, we found weaknesses in the Department’s process for linking policy to the equipment needed to fulfil the policy.

3.18 In 1992, we noted that the Department lacked a system for setting priorities in the Defence Services Program. The Department told us then that by mid-1993, reforms to the Defence Program Management System would provide the basis for full documentation of priority setting.

3.19 In 1994, we reported that the policy planning and force development process needed improvements to resolve gaps and make plans affordable. The Department did not have conflict scenarios to provide guidance to force development planners. The Department agreed to provide greater detail in its policy documents about the kinds of situations the Canadian Forces would face; it said affordability would continue to be a major priority. Program or policy changes would be made if appropriate.

3.20 Most recently, in 1996 we found that some equipment for the army, particularly for peacekeeping, was deficient for the missions and tasks being undertaken.

Focus of the Audit

3.21 The present audit was intended to determine how well the capital equipment program of about \$1.4 billion each year is doing at maintaining the modern, multi-purpose forces required by the government's policy. It was conducted in concert with the audit reported in Chapter 4, which examined how well the Department manages its projects to buy major capital equipment.

3.22 Further information on our objectives, scope and criteria can be found at the end of the chapter in the section **About the Audit**.

Observations

The Canadian Forces Are Trying to Cope with Equipment Deficiencies and Shortages

3.23 The Canadian Forces must maintain their core capabilities in order to be able to meet their commitments. The army, navy and air force each have roles that are essential to the success of the Canadian Forces in defending Canada and North America and contributing to international security. However, equipment deficiencies and shortages limit the capabilities available to implement the 1994 Defence White Paper. According to Department officials, the capabilities that are maintained define what Canada will accept as defence commitments.

3.24 In December 1997, the Deputy Chief of the Defence Staff asked the army, navy and air force to review their present ability to deploy Main Contingency Forces as called upon in the defence policy. This staff analysis is to be based on

current capabilities and is to be completed by April 1998. While the review is intended to define the current state of the Canadian Forces, it does not attempt to forecast their future effectiveness. In addition to this review, Mobilization Plans are being developed as directed by the defence policy and are also expected to be completed by April 1998. Finally, the Department informed us that it is also reviewing its Defence Planning Guidance document to address affordability and future force structure issues.

3.25 We examined the current deficiencies in equipment capability that the Canadian Forces have identified, and their assessments of how these deficiencies affect operations. We then reviewed equipment modernization plans and the time frames for correcting the deficiencies.

Naval task groups need better support

3.26 Defence policy requires the navy to have a balanced fleet able to deploy on both coasts. A balanced fleet means the navy can operate effectively on, above and under the ocean surface. We examined the navy's own assessments of its fleet and maritime air assets on the east and west coasts as well as for Canada's international obligations.

3.27 At the time of our audit, the navy stated that although it is well served by its surface fleet of modern warships, concerns remain about its helicopters and replenishment ships, which provide support, and its submarines. There are gaps in strategic surveillance and only a very limited capability to exert national will in the very demanding environment of Canada's Arctic.

3.28 The Department reported in 1997 that "critical deficiencies exist in the maritime helicopter and submarine fleets." The navy relies on the air force to provide air support for its naval task groups and to conduct maritime surveillance. In order to be effective at sea, the naval task groups require shipborne helicopters to operate

The Deputy Chief of the Defence Staff is currently reviewing the capability of the Canadian Forces to deploy the contingency forces called for in the White Paper.

with destroyers, patrol frigates and support ships. The Department has planned a project to address maritime helicopter deficiencies, but they will continue until new helicopters are delivered.

3.29 Lack of submarines has meant that the navy's ability to meet its obligations on the west coast has been limited since 1974 and it does not expect to have current deficiencies resolved until sometime after 2005. The navy has three submarines to protect Canada's coastline but in Maritime Command's Naval Vision, the Chief of Maritime Staff calls for up to six submarines to properly meet defence policy requirements. The existing vessels are over 30 years old and are becoming obsolete. Submarines are currently a defence priority.

3.30 According to the Naval Vision, the naval task groups call for four support ships for the east and west coasts to support operations and provide adequate strategic sealift capability. The navy is currently operating with only three support ships, and the planned retirement of *HMCS Provider* in 2001 will add to existing limitations. A project to replace

the support ships has been put forward for future consideration.

The army has difficulty keeping pace with technology

3.31 The government expects the army "to fight in joint, combined and coalition operations in all types of environments." It must be able to respond with existing resources to operations other than war and must also be prepared to mobilize should Canada have to fight a major war.

3.32 In the 1994 Land Force Development Guide, the army stated that operationally it had not kept pace with technology to modernize its equipment, leaving it vulnerable to threats in low-level and mid-level operations. Its infantry and armour could be detected, engaged and defeated long before it was known that an enemy was present. Canadian artillery could not fire effectively because of limitations on its ability to locate and identify targets. The army was struggling to acquire the 1970s and 1980s technology to fight air/land battles even though the next-generation "information battlefield" had already

Critical deficiencies exist in the maritime helicopter fleet needed to provide support and surveillance for the navy's ships (see paragraph 3.28).



arrived. Our review of departmental documents confirms that many of the 1994 Land Force concerns are still concerns today.

3.33 The army is introducing new technology as funding permits, but acknowledges the difficulty with the current pace of technological change. Since 1994, the army has initiated several projects to upgrade its equipment. For example, reconnaissance vehicle deficiencies are to be addressed by 1998–99: the Leopard main battle tank is being fitted with a thermal sight; and the army has received government approval to replace 240 of its armoured personnel carriers. It is also working on implementing a Land Force Command communications system by 2001, which, the army has informed us, will be fully interoperable with other Canadian Forces command and control systems.

3.34 But the army continues to face other ongoing deficiencies. Its armour combat vehicle has been considered unsuitable as an operational vehicle since 1981, and is particularly inadequate for peacekeeping. Although the thermal sight on the Leopard tank is being added, other upgrades to improve its firepower and armour have been delayed. The army is planning to replace only about one third of its armoured personnel carriers and to

upgrade the remainder. Departmental documents dated from 1994 to 1996 state that these vehicles could put troops at unacceptable risk when used on assigned missions. However, officials told us that the army's equipment rationalization program should go a long way to reducing the risk that troops could be exposed. Once implementation is complete, front line troops will be equipped with the most up-to-date light armoured vehicles while other troops will have upgraded armoured personnel carriers.

3.35 The army relies on the air force for tactical transport. The Griffon utility helicopter recently acquired for the air force is able to provide troop transport and conduct limited reconnaissance operations. It is capable of lifting the army's lightweight artillery only very short distances. With its Griffon helicopters, the air force cannot provide direct fire support for the land troops. However, trained aircrew can communicate with ground forces and co-ordinate fire support by using binoculars and following artillery procedures.

The air force is facing obsolescence

3.36 The air force faces "a serious risk of obsolescence and capability degradation in a number of key areas", as it reported in the National Defence

The army is introducing new technology as funding permits, but acknowledges the difficulty with the current pace of technological change. Problems identified in 1994 with infantry, armour and artillery are still concerns today.



The new Coyote replaces the army's old reconnaissance vehicles...



...while the new Griffon helicopter is mainly used for transport (see paragraphs 3.33 and 3.35).

1997–98 Estimates. Defence policy calls on the air force for seven key capabilities — fighter capability, strategic transport and air-to-air refuelling, tactical transport and air-to-air refuelling, support to the navy, support to the army, search and rescue and Arctic surveillance.

3.37 The air force currently believes it is not fully capable in all its core areas, but in some of its key capabilities it is better able to meet commitments than in others. For example, the strategic and tactical transport aircraft are able to provide airlift for passengers and cargo, and its tactical transport aircraft can do some air-to-air refuelling. The tactical transport aircraft need avionics updates to ensure that they remain effective until 2010, when they may be retired. A project is under way to have aircraft upgrades completed by 2000.

3.38 However, deficiencies in helicopters and other capabilities are of immediate concern and place real limitations on the ability of the air force to provide support to the navy and army. The air force has identified five areas in which capability deficiencies need to be fixed to maintain the minimum standard needed for interoperability with allies and for Canada's fundamental security needs — search and rescue helicopters, shipborne maritime helicopters, life extension of the Aurora patrol aircraft, systems life extension for the CF-18 fighter aircraft and region/sector operations control centres.

3.39 Buying new search and rescue helicopters has been a departmental project for over 10 years. The deficiencies of the current Labrador helicopters have recently been addressed by the government and new helicopters for search and rescue could be in use by 2003.

3.40 The Aurora maritime patrol aircraft was acquired in the early 1980s and now needs upgrades to address and update its limited maritime surveillance capability.

3.41 The CF-18 fighter aircraft is required for the defence of Canada and to meet international commitments to NATO and NORAD. It was acquired in the early 1980s and now lags behind advanced technology available in other aircraft that represent a potential threat. While the CF-18 now has precision-guided munitions and associated delivery systems, other components are reaching the limits of their capability. System upgrades to the CF-18 fighter aircraft are a priority for the Department. However, plans to implement them have been deferred.

Money for Capital Spending Is Shrinking

The Department cannot afford all the equipment forecast to fully modernize the Forces

3.42 The National Defence budget is divided into expenditures for personnel, operations and maintenance, some statutory payments as well as grants and

Main aircraft of the air force—the CF-18 fighters and Hercules tactical transports—need avionics updates (see paragraphs 3.37 and 3.41).



contributions, and capital. Capital funding includes money to modernize equipment for the Canadian Forces.

3.43 In 1987, the government became concerned that the gap between defence capabilities and policy commitments had become too great. It stated its intent to re-equip the military and prevent impending rust-out.

3.44 Despite recognition of the problems facing National Defence, like other departments it has had to cope with shrinking budgets. In 1988–89, at the end of the Cold War, the Department was spending about \$11.4 billion — about \$14 billion in current dollars. This year, it will spend about \$9.7 billion (1998–99), 30 percent less in real terms than a decade ago.

3.45 The internal demand for funds for personnel, operations and maintenance is growing. Each year as operating costs increase, less and less funding is available for capital expenditures. In 1988–89, National Defence spent \$2.2 billion on capital equipment, or about 20 percent of its budget, which in current dollars is about \$2.8 billion. Today its capital equipment spending has dropped by 50 percent in real terms to about \$1.4 billion

(1998–99), or 14 percent of the defence budget.

3.46 In 1996, the Department stated that it was “committed to avoid repeating the experience of the early 1970s when funding restrictions led to a rust out of major equipment. Over the longer term, the Department will have to address the need to return to a higher level of capital spending in order to prevent rust out.”

3.47 We examined forecast capital funding over the long term and found that unless significant adjustments are made, it could decline to a very low level. Although the National Defence budget is expected to increase to compensate partially for inflation, within the next 15 years — if current trends continue — spending on capital could approximate 1970s levels (Exhibit 3.1). Our analysis found that in the worst case, capital expenditures could drop as low as 9 to 12 percent of the defence budget by 2012–13.

3.48 The Department recognizes that equipment modernization would be unsustainable at a spending level of only 9 to 12 percent and explained that it would take and is taking action to prevent this situation from occurring. Nevertheless, departmental officials told us that hard choices may have to be made involving

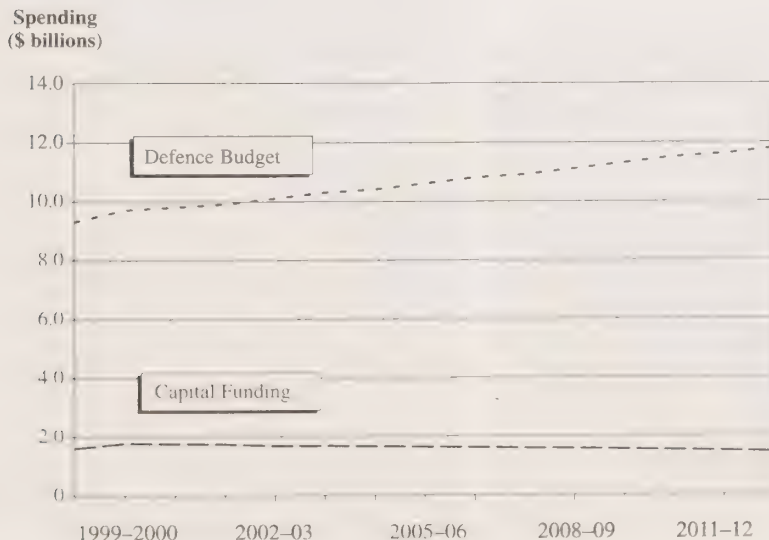


Exhibit 3.1

Forecast Trend in Capital Spending

Defence spending on capital may fall to very low levels over the next 15 years.

Source: DSP Internal Funding Distribution Plan; 22 January 1998

Officials said they are taking action, but that hard choices may have to be made.

several options that could be pursued, other than maintaining the status quo. Overall, the options are:

- to continue the status quo, annually reviewing the cost of projects so that long-term capital plans are kept within capital funding limits;
- to seek increased funding from government, some of which could be directed to capital, pursue additional internal efficiencies and reallocate some savings to capital; and
- to strategically rethink, over the long term, the structure and operations of the Canadian Forces.

Option 1: The status quo

3.49 The Department has identified capital projects to correct deficiencies in its equipment. Projects in the army, navy and air force as well as information technology business plans represent an estimated demand of almost \$11 billion on the capital budget over the next five years. However, the status quo would see only \$6.5 billion available for equipment spending. To meet all the requirements for these equipment projects, the Department would need to almost double the amount of funding it has allocated from its budget for equipment modernization.

3.50 The Department develops a Long-Term Capital Plan for equipment to identify which projects it can afford to undertake with the available funding, when it can start funding these projects and how much it can allocate to each of them.

3.51 The Department cannot undertake all the projects it has identified in its business plans; it will have to reduce, eliminate or defer some projects or project phases to later years until funding becomes available. Over time, as more and more projects are delayed, the Department will experience a growing amount of deferred expenditures needed to fix capability deficiencies.

3.52 **Defence is deferring more and more equipment projects.** Growth in the number of deferred equipment projects is an indicator of whether the Canadian Forces can keep pace with demands to modernize aging equipment and avoid rust-out. The government referred to this backlog of demands in 1987, indicating then that it had become a serious problem.

3.53 With the status quo, the amount required to fund deferred equipment projects could reach as high as \$5 billion over the next five years and we estimate between \$20 billion to \$30 billion by 2012–13. This is based on all the potential projects identified by the Department. Some of these projects could be reduced or eliminated as the Department reassesses its needs or finds less expensive ways to modernize equipment. At this point, however, the Department has not been able to say which projects could be redundant, or less expensive than now anticipated. As well, new projects could be added as other equipment modernization needs become apparent. As a case in point, we identified in current business planning documents almost \$300 million in potential new demands.

Option 2: Identifying more funding for equipment modernization

3.54 In the near term, the Department is seeking to increase its reference levels and compensate for rising personnel costs funded by reducing capital. These adjustments could add almost \$700 million to capital equipment funding over the next five years.

3.55 As part of its renewal efforts, the Department is adopting innovative business practices and identifying Alternative Service Delivery options that may result in significant savings. It is also targeting improvements in productivity to achieve savings in operations. For example, departmental officials told us they are considering reducing the frequency of personnel transfers; they estimate that this could save up to 50

percent of current moving costs, or about \$100 million per year.

3.56 This increased funding for equipment could, at the end of five years, reduce the amount of deferred equipment spending to less than \$4 billion. In addition, in the Department's opinion, current project cost estimates can and will be reduced, which could provide a less costly picture of deferred demand. However, as we note in the next section, some costs appear to be increasing.

Option 3: Long-term strategic rethinking of the Canadian Forces

3.57 Should funding prove inadequate to sustain the current force structure, re-examination would be required. The Department has already initiated a long-term examination of the Canadian Forces. Its plans include examining capabilities, future force size, force development priorities and new ways to support operations. The objective is to

ensure that the Canadian Forces of the future can provide adequate defence capability.

3.58 This strategic rethinking of the military may require significant changes to the Canadian Forces in order to operate within funding limits. Department officials stated that it may be necessary to reduce the number of military and civilian personnel. Changes may be made to the force structure that would require less or different equipment than is currently needed. Readiness may be reduced to levels that would require longer notice than the current 90 days to be able to deploy, and might require a strategic warning period of several years. These options will be examined in context with the role the government expects the Canadian Forces to fulfil and the funding provided to maintain capabilities.

3.59 Overall, officials told us that the first option — maintaining the status quo — is the least likely to be selected.



Maintenance on aging equipment...

...can be time-consuming and costly (see paragraph 3.60).



Neither curtailing operations nor replacing old equipment is likely to generate enough savings on operations and maintenance to fund needed modernization.

Rising Costs of Operating Equipment Put Capital Funds at Risk

3.60 The decline in capital funding is partly due to growing pressure on the National Defence budget from the rising costs of operations and maintenance (O&M). As equipment ages, it reaches a point where labour and spares required for both upkeep and repairs make it increasingly expensive to maintain and it spends more time out of service. New, more technical equipment, while providing improved capability, can cost more than the old to operate and maintain. Keeping O&M costs within budget is an ongoing challenge.

3.61 In its 1996–97 Business Plan, the Department reported that it had introduced “changes to infrastructure, support concepts, operating tempo, equipment fleet mixes, as well as many re-engineering and information technology initiatives which will permit net operations and maintenance costs to be constrained to approximately 30 percent of available funding.” Despite this effort, our analysis of expenditure plans shows that spending on O&M will exceed the 30 percent target by next year (1999–2000).

3.62 The Department has considered reducing operations as one way of containing O&M costs but has concluded

that little or no savings would result. A recent study by the US Congressional Budget Office also found that there was only a limited relationship between trends in O&M spending and operating activity. Similarly, we agree that National Defence is unlikely to contain O&M costs by reducing its activity levels. We found that such a large portion of O&M expenditures are fixed costs that it would be difficult to create short-term savings. About 15 percent of total O&M costs vary with equipment usage and the remaining 85 percent are either fixed equipment costs or are not related to equipment (Exhibit 3.2). Therefore, reducing equipment use would create only a small amount of savings in O&M overall. For example, we estimate that a 10 percent reduction in air force flying hours would reduce aircraft O&M costs by only 3 percent. A 10 percent reduction in navy time at sea would reduce ships O&M costs by only 2 percent. Finally, a 10 percent reduction in the use of army vehicles would reduce their O&M costs by only 4 percent.

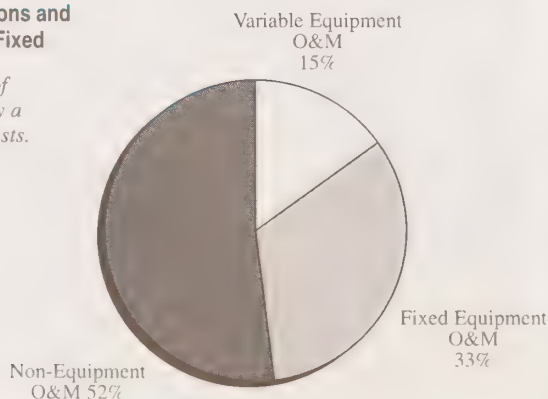
3.63 The Department identified several other actions it has taken to contain O&M by reducing non-equipment O&M spending like infrastructure and dependency support. However, the expected savings have yet to be fully realized. For example, O&M funds for the maintenance of vacant infrastructure and for dependency support are still being spent at army bases closed during the Infrastructure Adjustment Program, and overall army infrastructure has increased. The army noted in its Report on the Fundamental Review of Operating Budgets, “Infrastructure increases [are] cause for serious concern over the long term as available O&M funds are spread ever more thinly and as rust-out starts to impose its inevitable grip.”

3.64 In the past the Department has reduced O&M allocations across the board rather than targeting specific areas. There is a risk that such reductions will not actually be realized. The army has already

Exhibit 3.2

Most Equipment Operations and Maintenance Costs Are Fixed

Cutting back on the use of equipment will affect only a small percent of O&M costs.



experienced difficulty keeping expenditures within targets. It estimates that the gap between its O&M needs and budgeted funding will grow to almost \$140 million by next year (1999–2000).

3.65 Other commands have also forecast shortages in O&M funding. The air force is at a critical point: current funding is barely adequate. In its planning documents it states, “Because force structure and cost analysis planning tools are still under development, it remains to be seen whether CC3 [the air force] will be able to effectively meet the tasks and commitments called for by the Defence Planning Guidance 97 with the operations and maintenance resources provided.” The navy has stated in its 1997–98 plans that the operations it can perform within the O&M funding available represent a very lean program for the navy and, although the navy will meet its assigned missions, this will not be to the standard preferred.

3.66 O&M is managed within the budgeted funding, but estimated needs often exceed the funds available. The Materiel Group has estimated the gap between the Department’s O&M needs and its budgeted funding. The gap is currently forecast at \$240 million during the first year of the current five-year planning period (1998–99) and \$334 million the following year. We estimate that if the identified gaps could be addressed, O&M would approach 35 percent of departmental expenditures.

Buying new equipment puts more pressure on the budget

3.67 In order to maintain O&M costs at current levels, the Department is calling for the O&M saved on equipment being replaced to fund the O&M costs of the new equipment. However, new equipment may be more costly to operate and maintain than the old.

3.68 Indeed, new equipment could cost the Canadian Forces two to three times more to operate and maintain than

the equipment it is now using. For example, the army’s new reconnaissance vehicle, the Coyote, is expected to cost \$15.4 million per year to operate and maintain — 275 percent more than the vehicle being retired. Operating and maintaining the new Griffon helicopter may cost the air force 20 to 40 percent more than the three helicopter fleets it is replacing, based on the data available at this time.

3.69 As new equipment is purchased, or more sophisticated equipment acquired, O&M costs are likely to increase. And as O&M becomes a larger share of the defence budget, less funding is left for capital purchases needed to replace other aging equipment. An analysis conducted by Dr. John Treddenick at the Royal Military College found that under current plans, the Department will experience increasing O&M and personnel costs, which demand greater shares of its budget. His analysis warns that within the next 15 years, little funding may be left for capital acquisitions (Exhibit 3.3). Under these circumstances, the Department is facing increasing rust-out as its ability to purchase new equipment declines.

Equipment Modernization Needs Better Guidance

3.70 Weapon systems have a very long service life — often 30 years if upgraded throughout their life cycle — and can cost billions of dollars. Decisions on how a force is to be equipped are therefore very important and need to be part of a long-range strategic plan. We examined the Department’s plans to determine if policy and doctrine were specific enough to guide major acquisitions; if there were operational scenarios in place to describe what equipment was supposed to be able to do; if performance information was sufficient to alert officials to areas where capabilities were declining and required renewal; and if there were clear priorities to guide investment.

The 1997 departmental fall Performance Report to Parliament did not report that hard choices may have to be made.

Performance information is not yet available

3.71 The Department of National Defence has had some success in developing its performance measurement framework but less success in producing targets and measuring outcomes. The 1997 Performance Report provided information on expenditures that was much like the Part III Estimates, rather than reporting on how well key results expectations were met.

3.72 The Department has not yet fully developed performance measures that would enable decision makers to judge how well the Canadian Forces are operating and where to focus efforts. As one command has reported, “The absence of a credible performance measurement system remains a major impediment to the capability planning process.”

3.73 The new departmental fall Performance Report and the Spring Report on Plans and Priorities replace Part III of the Estimates and are intended to provide Parliament with improved performance information. However, the Department does not have a financial system that allows it to report on its business lines — Defence of Canada, Defence of North America and Contribution to International

Security. Financial and performance information, providing measurable performance expectations with a focus on outcomes, will not be available for two more years. Distinct from what our audit found, the 1997 Performance Report has not reported to Parliament that “hard choices” may have to be made.

Priorities are not clear

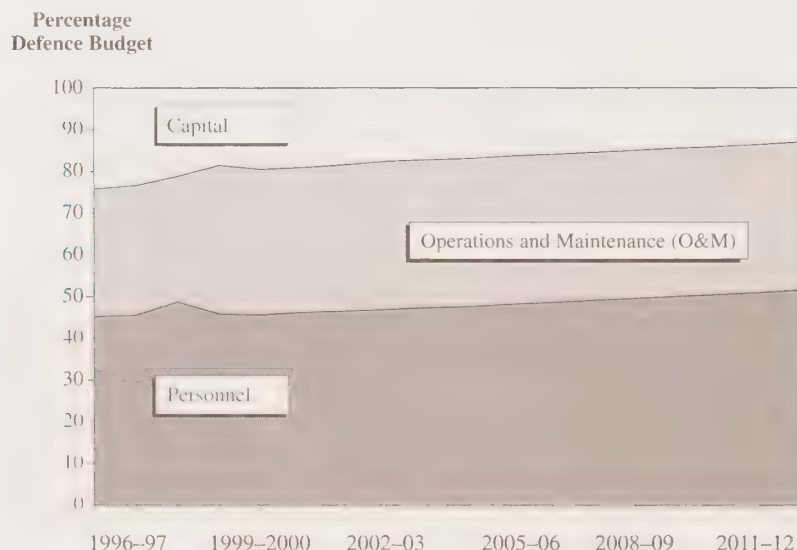
3.74 In order to focus on their most pressing needs, the commands and the Department have stated their priorities for capital equipment acquisition. Each year the army, navy and air force plan how they will spend the resources allocated to them. However, as noted by one of the commands in its plans, “Without both a defence task priority model and activity based costing of all processes and sub-processes, we will continue to allocate departmental resources to capability components more on ‘gut feel’ than ‘good management.’”

3.75 Annually, the Department issues its Defence Planning Guidance to all commands to provide strategic guidance. Using this guidance, the commands develop their business plans for the following year, and determine their equipment needs. In their plans they

Exhibit 3.3

Forecast Capital Spending Trends in Relation to Other Spending

Forecasts show capital expenditures are a decreasing portion of the defence budget as O&M and personnel expenditures increase.



define their command equipment priorities.

3.76 Setting overall departmental priorities is the responsibility of the Defence Management Committee. We found no evidence to indicate what criteria the Department uses, other than statements in the White Paper that the Department is to emphasize equipment life extension and maintenance of “core capabilities”. According to the Vice Chief of the Defence Staff, the process is adversarial and concludes with senior direction that balances requirements and affordability.

Scenarios to guide planners are not fully developed

3.77 In 1994 we commented that scenarios were necessary to describe the circumstances in which the Canadian Forces might be employed. These scenarios then would allow planners to select equipment. At that time the Department agreed with our assessment and, in 1996, stated that it was developing scenarios. Its Defence Planning Guidance 98 notes that while scenarios are still in the development stage, the Department remains committed to meeting the requirement and included the descriptions of 11 scenarios that are being more fully developed. The Department informed us that these scenarios are being used, in a limited way, to review force structure and capital equipment priorities. Nonetheless, capability assessments and decisions on equipment acquisition are currently being undertaken without benefit of fully developed and approved force planning scenarios to determine the needed levels of capability, readiness, sustainability and deployability.

A framework is needed to guide modernization

3.78 Defence policy defines national interests and objectives and states how defence capabilities contribute to them.

The Special Joint Committee on Canada’s Defence Policy stated, “It is the government’s responsibility to balance Canada’s security interests within a wider context of policy and national objectives.” It went on to say, “Canada’s military activities must be explained and justified as an essential instrument of government policy.”

3.79 The White Paper calls for the Canadian Forces to be more than a constabulary force but does not clarify what this means. The government’s intention is defined as being able to “fight alongside the best, against the best.” According to departmental officials, the circumstances set out in the White Paper under which the Canadian Forces would be employed were determined by the capabilities that the Canadian Forces could provide.

3.80 In order to link policy expectations to defence capabilities, military forces develop doctrine that specifies the sort of operations they intend to conduct, how they will conduct them, and the kind of forces they will require. Using this doctrinal guidance, force planners identify the structure necessary to meet the commitments the government has outlined in its policy. This framework of policy/doctrine/force structure enables the military to plan strategically for personnel, equipment and readiness, and to determine whether deficiencies exist. In the Outlook on Force Development, on the Vice Chief of the Defence Staff Internet home page, officials state in a draft document that more work needs to be done to fully link policy with defence capabilities. It states, “Where the current system falls short is in the area of long-term development. The processes, systems and structures to ensure that the long-term development of the Canadian Forces as a whole is synchronized are not yet fully established.”

3.81 In examining the Department’s policy and planning framework, we expected to find clear statements of the

military capabilities to be maintained, the force structure and posture to be adopted and the relative priorities placed on capabilities. To plan equipment requirements, the Department needs to be able to address fundamental questions about the nature of the capabilities that must be maintained, how much is enough, and the risks that the military will be called on to face. For example, should the Canadian Forces acquire equipment for mid-intensity operations or focus only on low-intensity operations? And if mid-intensity operations are to be conducted, how does the military intend to carry them out?

The Department needs to be able to address fundamental questions about the nature of the capabilities that must be maintained, how much is enough, and the risks that the military will be called on to face.

3.82 Guidance on the nature of missions and tasks is an important component of planning for the long term. As part of its Management Command and Control Re-engineering (MCCR) initiative, the Department developed an annual Defence Planning Guidance (DPG) document to serve as strategic-level guidance to commands. The DPG document allocates resources, states priorities and identifies the capabilities required by each command. However, it covers only a five-year planning time frame. It does not provide a long-term vision of how the military will operate. In its Outlook on Force Development, the Department notes that a drawback to using the DPG for strategic planning is that it is tied to a five-year budget cycle.

3.83 Strategic guidance is needed to govern the selection of priorities and to allocate resources accordingly. To review force planning effectively and link it with policy, the Department has found it necessary to examine its strategic-level doctrine. The army, navy and air force explained to us that they are reviewing or have recently reviewed their doctrines.

Some Countries Are Better Able to Match Defence Requirements to Resources

3.84 We examined the extent to which other countries could match defence resources to requirements. We reviewed the experiences of the United States, Australia, New Zealand and the United Kingdom.

Other countries are doing better

3.85 Like Canada, other countries have estimated that they need more funding than they have available for military equipment modernization. The United States Department of Defense estimates it needs about US\$60 billion each year for modernization, but it spent only \$45 billion in fiscal year 1997. New Zealand also determined that it could not adequately modernize its forces within its current budget; it received an increase for the next five years. Similarly, Australia and the UK are reviewing their capital spending and both have identified some gaps in capabilities. The Australian Defence Force intends to alleviate funding pressures in the short term by reducing overhead costs, but has identified significant funding deficiencies in the medium term that will require the Australian government to consider an increase in resource allocation. The UK defence policy is under review and resource levels are being assessed.

3.86 Australia, New Zealand and the United States have all completed major assessments of the adequacy of funding for their defence policies. Each country has completed its own defence review to find the right balance of resources and commitments. The US Department of Defense conducted its Quadrennial Defence Review to examine how resources and requirements are connected.

This followed its Bottom Up Review to look at the objectives of U.S. defence policy and the resources needed to meet them.

3.87 Canada last reviewed defence objectives and budgets during the 1994 White Paper exercise. At that time, Parliament was involved extensively through its Special Joint Committee on Defence Policy. The Special Joint Committee recommended higher force levels and budgets than those to which the government eventually agreed. Defence planners told us they had preliminary knowledge of 1995 budget reductions when they drafted the 1994 White Paper.

3.88 New Zealand and the United States have an advantage that the Canadian defence management system cannot currently provide — the ability to match outputs and policy goals to resources and to provide performance information on how well goals are achieved. New Zealand has an extensive government-wide process for matching resource inputs to program outputs. Its Chief of the Defence Force and the Minister agree on the deliverables of the Defence Force in a purchase agreement that provides financial statements for each deliverable. Performance reporting informs the Minister and Parliament whether goals have been met. In Canada, department-level performance measurement is close to implementation but is not yet in effect.

3.89 The U.S. Quadrennial Defence Review has been successful in measuring the gap between requirements and resources and proposes a step-by-step action plan its drafters believe will address the gap. Performance information on the readiness of the U.S. military is reported to both the Secretary of Defense and to the President. The U.S. process includes a structured challenge review by an independent panel of experts. This panel has contested the viability of some aspects of the Department's resource plan.

3.90 Canada, Australia and the UK have resource management systems that are not as well developed as those in the U.S. and New Zealand. Australia intends to adopt program budgeting and accrual accounting to track the resources needed to meet the policy requirements. Canada and the UK both intend to adopt accrual accounting in the next few years.

3.91 One commonality evident in the countries we examined was the high level at which outputs and the resources needed to achieve them are reviewed. Annual top-level guidance from the President and the Chairman of the Joint Chiefs of Staff is fundamental to the U.S. process. Reported results of U.S. military performance are challenged by Congress and the General Accounting Office. Congress has a strong role in the annual budget process and is provided with the program information it needs for decision making.

3.92 The system in New Zealand requires the Minister and the Chief of the Defence Force to come to an agreement on what can be accomplished with the resources provided by government; they are bound by that agreement to deliver. Performance is also reviewed by the Treasury. The Defence Force can then discuss with the Treasury the resource gaps that exist. Reports on what has been delivered are audited by the Comptroller and Auditor General, who has confirmed the reasonableness of the reported activities. His Office has advised Parliament that the systems used to collate and report the activities are “sensible, feasible and measurable”.

3.93 Canada has recently instituted a new Expenditure Management System to help the government make responsible spending decisions by delivering the programs and services Canadians need in a way that is affordable. Key features of the new system include multi-year funding targets for all departments and annual Performance Reports to Parliament. At the time of our audit, the Performance Report

High-level review of defence policy objectives and resources is characteristic of countries that are managing better than Canada.

of National Defence was still evolving and contained little performance information that could be used to assess the overall success of the program. Officials estimate that two more years will be required to complete the system.

3.94 The UK House of Commons Defence Committee traditionally reviews the Defence estimates as part of its role to examine the expenditure, administration and policy of the Ministry of Defence. The Committee receives copies of the Government's Statements on the Defence Estimates, Departmental Spending Plans and Departmental Reports, all of which are publicly available, and takes oral evidence from ministers and officials before making a report to the House of Commons. On this basis, it can assess the adequacy of resources and it has raised some concerns.

3.95 In Australia, as in the UK, there are limits on the extent to which parliamentarians can assess spending plans. The Joint Standing Committee on Foreign Affairs, Defence and International Trade is soon to report on its inquiry into the level of funding required by the Australian Defence Force.

3.96 In Canada, the Standing Committee on National Defence and Veterans Affairs reviews the Defence Estimates each year. The new Expenditure Management System is intended to improve parliamentary participation, but better performance information is required.

3.97 Overall, the United States and New Zealand systems appear to do the best job of explicitly linking defence policy or outputs to resources. Australia, Canada and the UK are at about the same stage in improving their top-level resource management systems. All of them are working on implementing accrual accounting, and Canada and Australia are developing performance budgeting or reporting systems. In both Australia and the UK, Parliament has played a more

active role in the oversight of defence spending than in Canada.

Conclusion and Recommendations

3.98 While progress has been made in several areas, some of the problems we reported in the past remained unresolved at the time of this audit. National Defence has equipment deficiencies and shortages that limit how well the Canadian Forces can respond to government objectives. Not all the equipment required by the Canadian Forces to correct these deficiencies and to modernize is affordable within the current budget allocations for capital equipment acquisitions. In order to provide the resources required for force modernization, the Department will need to make some difficult choices regarding funding allocations. As other countries have already done, Canada must also ensure that the resources made available for defence match the capabilities that the Canadian Forces are expected to provide.

3.99 The Department should complete its scenarios, force development framework and strategic assessments with a focus on future force development of the Canadian Forces and the resources it will need to do its job.

Department's response: This recommendation is being implemented. The Department is already using basic scenarios as a guide to planning, which will be expanded upon by the end of 1998. The Department has also developed a new Strategic Assessment document, which will be updated annually, to guide future defence planning and force development activities.

3.100 The Department should provide sufficient information on military capabilities, performance and resources to Parliament so that Parliament can better review the Department's

Estimates. As in some other countries that are reviewing the performance of their defence forces, the Department should link its defence capabilities to the resources provided so that Parliament can examine whether National Defence's resources match Canada's defence objectives.

Department's response: The Department is implementing this recommendation. DND's Planning, Reporting and Accountability Structure (PRAS) has been submitted to Treasury Board. This framework clearly links defence activities and their associated resources to desired results.

Department's comment: While Canada requires modern, multi-purpose, combat-capable forces, government policy clearly requires the Department to be cost-effective. The responsible stewardship of Defence resources demands that the Department consider both quality and quantity for Canadian contributions to proposed military operations. The Department recognizes that the Canadian Forces do not always require the most sophisticated or the most modern equipment to fulfil the defence mandate and to provide a meaningful and effective response in support of Canada's defence requirements. The Department also recognizes that there are many program-related challenges surrounding efforts to develop and maintain a balanced Defence Services Program.

At paragraph 3.66, the Chapter indicates that a significant O&M funding gap exists

and that addressing this gap could see some 35 percent of departmental expenditures dedicated to O&M. The Department has committed to living within the resources assigned by Parliament. One solution to the O&M challenge would be to allocate a greater percentage of the defence budget to this area. However, the Department has directed that all elements seek out and implement business efficiencies aimed at achieving more cost-effective use of available resources. In this regard, there has been considerable success and more is anticipated. Although more funds could be directed toward O&M, it is vitally important that balance be maintained in the program in order to satisfy other major cost-drivers such as capital expenditures and personnel.

Paragraphs 3.35 and 3.68 of the Chapter discuss the Griffon helicopter. The report states that the Griffon cannot provide helicopter-mounted direct fire support to ground forces and notes that there may be a significant increase in operating costs relative to the three helicopter fleets it replaced. Regarding helicopter-provided direct fire support, such support would be provided, if required, by other Canadian or Allied aircraft. The Griffon satisfies its intended role in Canada's defence strategy. With regard to costs, the data used by the Auditor General compare aircraft at the end of their useful service lives with a new platform. In view of this, the Department believes that this issue requires more study and an internal review has commenced.



About the Audit

Objectives

The overall objective of our audit was to determine whether the policy and management framework of the Department of National Defence provided long-term, strategic guidance for equipment planning. We specifically asked whether:

- there is an effective framework through which government direction on commitments is translated into plans for equipment modernization for the next 15 years;
- National Defence can achieve the level of equipment modernization necessary to allow the army, navy and air force to meet their policy commitments; and
- the Department has been successful in addressing gaps between capabilities and commitments that have been of concern since the 1970s.

We also reviewed the experience of other countries to determine how well Canada's allies have coped with decreasing defence resources. We studied how the United States, Australia, New Zealand and the United Kingdom assess their defence policy commitments, modernize their armed forces and review performance.

Scope

Our audit focussed on National Defence plans to re-equip the Canadian Forces and ensure that the commitments called for in the 1994 Defence White Paper policy are met. We based our audit on the Department's own identification of equipment deficiencies and capability gaps.

We examined the Department's policy framework used to translate policy commitments into capital equipment plans. We reviewed the new management system employed to provide commands with planning guidance for the development of command-level business and long-term capital plans.

We also examined projects the Department has identified as needed to address capability deficiencies and gaps in meeting policy commitments. We reviewed the supporting documentation for approximately 80 major capital projects in which the army, navy and air force have reported limitations in the equipment they are using, shortages in equipment and risks they face if called upon to use the equipment in conflict situations. For our analysis, we reviewed authoritative departmental documents that had been approved by senior military officials.

Finally, we examined the funding for capital and the resources needed to meet policy commitments.

Criteria

We expected the following:

- a framework in National Defence to link policy, doctrine and force structure to defence capabilities and to identify any capability deficiencies;
- a long-term, strategic view of defence equipment requirements based on assessments of capability, readiness, sustainability and deployability;
- performance assessments by the Department of its ability to meet its policy commitments, based on performance targets and key results expectations, and plans to resolve how targets and expectations will be met in weak areas; and
- a visible priority-assessing and -setting system in place, based on missions and objectives, that allows senior management to choose, at the departmental level, between the competing priority needs of each command.

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Chapter 4

National Defence —

Buying Major Capital Equipment

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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National Defence — Buying Major Capital Equipment

Main Points

4.1 National Defence plans to spend almost \$6.5 billion over the next five years to purchase equipment that Canada's armed forces need to carry out their assigned tasks. As Chapter 3 indicates, the Department's available capital funding may not be sufficient to equip and modernize the force that is currently planned.

4.2 This chapter reports our findings on the management of six major capital projects with a total value of \$3.3 billion.

4.3 All six projects we examined are likely to meet their contract cost and performance objectives. For example, the Eryx anti-tank missile system and the Coyote reconnaissance vehicle appear to perform especially well and have attracted the interest of foreign armed services. Nevertheless, we are concerned about several of the management practices we observed.

4.4 We found that defence policy allows wide latitude in the level of equipment capability required. We noted in the projects we examined that affordability constraints resulted in only low-end capability being purchased, limitations in the number purchased, or both:

- the Maritime Coastal Defence Vessel is acquiring two sets of mechanical minesweeping gear for 12 ships effective only against some types of mines, and has not acquired some of the equipment necessary to patrol effectively in darkness and poor visibility;
- the Leopard C1 tank is being fitted with only an improved sight, although the army had considered a complete upgrade, including the gun and armour, to be the "minimum viable" option;
- the Griffon helicopter cannot meet the army's original lift and communications requirements;
- fewer Eryx missiles and Coyote vehicles have been purchased than were originally intended.

4.5 We are concerned at the extent to which the Department relies on professional judgment in making complex purchase decisions. Management did not conduct adequate analyses to justify its spending decisions for most of the projects we examined. Tactical studies often did not reflect the way officials said they actually planned to employ equipment, were done too late to influence decisions, produced results that contradicted the purchase decision, were undertaken by contractors who had an interest in the Department's decision, or were not done at all.

4.6 In three cases, the Department considered only a single option. In other cases, the options analyses were inadequate.

4.7 Only one project of the six fully met our expectations for a rigorous risk management process. No project we examined has suffered major problems so far because of this, but we identified several instances where better risk management might have improved project delivery.

Main Points (cont'd)

4.8 Although test and evaluation processes were satisfactory in most cases, for some of the projects that involved commercially based designs, the equipment was not tested under actual operating conditions until after it had been introduced into service. Problems have since been discovered that have affected the operational capability of some of the equipment. The Department is currently working to resolve these problems.

4.9 The Department began a major management renewal program in 1994 that included the capital acquisition process. Because it considered other areas to be more important, it deferred work on capital equipment acquisition and it does not yet have an implementation plan. The Department has begun work on the plan, including three pilot projects. Because equipment acquisition is a government-wide process, the Department is working with Public Works and Government Services Canada, Industry Canada, and the private sector to improve government practices. We believe the departments concerned must develop a plan with definite dates and milestones to complete their reform process.

Introduction

4.10 National Defence's 1997 long-term capital plan projects approximately \$10 billion in total capital expenditures over the next five years. Of this amount, \$6.5 billion will be spent to purchase capital equipment needed by Canada's armed forces to carry out the missions and tasks assigned by the government. While the end of the Cold War and the government's deficit reduction initiatives in recent years have resulted in significant reductions to defence capital expenditures, the defence capital program continues to be the largest in government. Our audit included the six major capital projects described in Exhibit 4.1.

4.11 Defence capital acquisition decisions affect how well the Canadian Forces can implement defence policy. The amount and type of equipment they purchase directly affects their ability to carry out their roles, which in turn determines how and where the government can deploy them.

4.12 Major defence capital equipment acquisitions involve several departments (see Exhibit 4.2). National Defence (DND) is responsible for establishing that the equipment is needed. It provides the operational and technical specifications and sets funding and scheduling priorities. The Treasury Board Secretariat provides general policies and guidelines for all aspects of project management. Public Works and Government Services Canada supports the procurement strategy, is responsible for the contracting process and is responsible for ensuring successful product or service delivery to DND through monitoring of the contractors' performance. Industry Canada, in consultation with regional economic development agencies, is responsible for industrial and regional development initiatives to be attached to major capital projects. The three departments together

assess options and make recommendations to ministers.

4.13 A defence project management team exists primarily to monitor the progress of the project and inform senior decision makers in the Department of National Defence of any significant difficulties that might jeopardize compliance with the contract. The team also plans and co-ordinates the introduction of the new equipment capability into the forces, including equipment testing and evaluation, user trials and the determination of spare parts requirements.

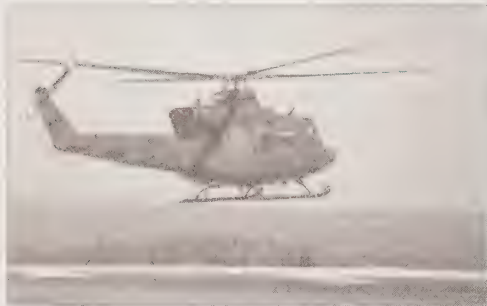
Focus of the Audit

4.14 Performance shortfalls, schedule delays and cost increases are problems traditionally associated with defence capital acquisitions, which we have reported in previous years. Given the risks and complexities of defence capital equipment projects, we recognize that the total elimination of these problems is not an attainable goal. However, such problems can be minimized if appropriate project management practices are followed. The essential elements of project management are described in departmental and Treasury Board policies and manuals, and include:

- an analysis of requirements that examines costs and alternatives to ensure that cost-effective solutions are matched to valid needs before substantial resources are committed;
- the assessment of risks and the implementation of a project risk management plan;
- testing and evaluation of equipment at various stages to ensure that technical specifications and user needs are being met;
- sound project monitoring and reporting practices; and
- human resource management.

Exhibit 4.1

Projects Selected for Audit



Canadian Forces Utility Tactical Transport Helicopter (Griffon) Project

The purpose of the Griffon project is to acquire 100 helicopters to accomplish national and international utility tactical transport helicopter roles. The primary task is tactical lift of troops and equipment. Other tasks include Base rescue flight, inland search and rescue, Joint Task Force 2 (the federal government's emergency response team), United Nations peacekeeping missions, medical evacuation, major air disaster response, surveillance, drug interdiction, firefighting, assistance to civilian authorities and to the civil power and command, liaison and communications assistance.

The Griffon is intended to replace three aging fleets — the CH-118 Iroquois, the CH-135 Twin Huey and the CH-136 Kiowa. Several

helicopter models were evaluated against operational requirements and the Bell model 412hp was selected, to be enhanced with various mission equipment.

The project was approved by Cabinet on 7 April 1992 and by Treasury Board on 8 September 1992. On 9 September 1992, a contract valued at \$754.5 million was awarded for 100 Griffons, a flight simulator, and other equipment, documentation and services. The first helicopter was delivered in March 1995, and the last helicopter delivery was in January 1998. The total estimated cost of the project is \$1.2 billion.



Maritime Coastal Defence Vessel Project

The Maritime Coastal Defence Vessel Project will address the significant deficiency in Canada's capability to defend Canadian ports and coastal waters, particularly the requirement to have sufficient assets in place to ensure, within 48 hours of mine countermeasure effort, that routes from the vital military ports of Halifax and Esquimalt to deep water are free from mines. The project involves the acquisition of 12 Maritime Coastal Defence Vessels (MCDVs) to enter service between 1995 and 1999. The MCDVs will be crewed primarily by the Naval Reserve and, accordingly, are intended to serve as the cornerstone of the Naval Reserve's revitalization.

In August 1988, the government provided approval-in-principle for the acquisition of the 12 MCDVs. Subsequently, Treasury Board authorized

resources for project definition activities and the procurement of essential early training equipment during the period 1988 to 1992.

In July 1989, following competitive bidding, two Canadian prime contractors were awarded contracts valued at \$4.5 million each, to conduct project definition studies and submit implementation proposals and offers, including MCDV designs. An interdepartmental evaluation of the two studies and proposals was conducted and recommendations were submitted to ministers on the selection of a prime contractor for the implementation phase of the project. Cabinet approved the project and selected the prime contractor in October 1991. Following contract negotiations, Treasury Board gave effective approval as well as contract approval for the project in April 1992. The total estimated cost of the project is \$708 million.



Leopard Thermal Sight (LTS) Project

On 19 September 1996, Treasury Board gave effective project approval for a thermal sight for the Leopard tank. The thermal sight will be obtained by procuring surplus Leopard 1A5 cast turrets fitted with the EMES 18 thermal sight from Germany, refurbishing these turrets and exchanging them with the welded turrets currently on the Leopard C1. Refurbishment and exchange of turrets has been awarded to a German tank manufacturer while maximizing Canadian content. Surplus equipment will be disposed of through the prime contract. The total estimated cost of the project is \$145 million.

Short Range Anti-Armour Weapon (Heavy) (Eryx) Project

The purpose of the Eryx project is to replace the Carl Gustav rocket launcher as the primary short-range anti-armour weapon of the Canadian Land Forces.

This project represents the first Canada-France co-operation on defence equipment and is expected to serve as a model for future bilateral undertakings.

Effective project approval was granted by Treasury Board on 17 March 1993. An initial \$81 million main contract for the acquisition of the Eryx weapon system was awarded in March 1993. As of 27 June 1997, as a result of follow-on procurement of spares and of the Mirabel thermal imager, the main contract is now valued at \$119 million. In addition, a contract for \$5.4 million was awarded to Aerospatiale to arrange for four Canadian companies to manufacture components of the Eryx. Three of the four companies are now producing the required parts for incorporation within the weapon system. The total estimated cost of the project is \$179 million.



Electronic Support and Training (EST) Systems Project

The EST Systems Project was approved to define, identify, procure and install equipment necessary to provide the Canadian Forces land, sea and air elements with effective airborne electronic warfare (EW) training. This training will prepare the Canadian Forces for effective operations in an EW threat environment.

A contract was awarded on 1 April 1988 to carry out the definition phase of the project. Preliminary studies revealed that this EST requirement could be met most effectively by a combination of appropriately equipped Challenger CL-600 aircraft, EW training pods carried by CE-133 aircraft (T-Birds), and EW simulators, which will be procured under a separate project.

Negotiations were conducted for the implementation proposal and resulted in the award of an implementation contract on 1 March 1993. A contract to design the aircraft modification to carry the new EW pods on the CE-133 aircraft, install it on the prototype aircraft and produce nine additional modification kits was awarded on 15 July 1994. The total estimated cost of the project is \$203 million.



LYNX Replacement (Coyote) Project

In 1992, the government announced the intention to procure up to 229 light armoured reconnaissance vehicles and associated support for the Canadian Forces to replace the Lynx command and reconnaissance vehicles, which were no longer operationally suitable. The Coyote provides the army with reconnaissance capability.

A contract was signed in March 1993. Total cost approved by Treasury Board was \$883,686,000 budget-year dollars. The vehicles were delivered between March 1996 and January 1998.



4.15 Our audit included all these aspects of project management as well as a comparison of the Department's practices and renewal efforts with best practices elsewhere. More details on how we conducted the audit are presented at the end of the chapter in **About the Audit**.

Observations and Recommendations

Previous audits showed the need to improve the capital equipment acquisition process

4.16 In previous audits, we found that the Department's process for acquiring major capital equipment needed to be improved.

4.17 In 1992, we reported that DND had recognized the need to simplify and streamline its major capital acquisition process, which had become unnecessarily complex, process-driven, costly and no longer appropriate for the management of the defence capital program. Our 1994 chapters on Information Technology and Infrastructure Management pointed to

continuing problems with the Department's project and program management systems, despite attempts to improve them. Our 1994 follow-up chapter also noted that while the Department has generally concurred with our recommendations, it has been slow to implement improvements. We also expressed our concern that the actions it has taken may be inadequate to address the problems with the project and program management systems.

4.18 Many of the problems associated with the purchase of major capital equipment that we found in our 1984, 1987 and 1992 audits continue to affect today's defence capital acquisition projects. The Department recently confirmed the persistence of these problems in a re-engineering study that examined capital project management from end to end. The study stated that capital acquisitions continue to be adversely affected by:

- an excessively complex and labour-intensive acquisition process;
- inadequately trained project managers;

Exhibit 4.2

Organizational Responsibilities for Major Capital Projects

Cabinet	<ul style="list-style-type: none"> • Approves major capital project proposals and funding
Treasury Board Secretariat	<ul style="list-style-type: none"> • Issues capital acquisition policies and guidelines • Provides recommendations and advice to Cabinet on whether major capital projects should be approved, based on an analysis of departmental proposals
National Defence	<ul style="list-style-type: none"> • Defines the requirement • Analyzes options • Provides operational and technical specifications • Sets funding and scheduling priorities • Monitors project implementation by prime contractors
Public Works and Government Services Canada	<ul style="list-style-type: none"> • Assists in developing procurement and contracting strategy • Manages contracting process
Industry Canada	<ul style="list-style-type: none"> • Ensures implementation of socio-economic objectives

- insufficient resources and underestimation of supportability costs;
- an ineffective and untimely staffing of project management offices;
- gaps and overlaps in project management responsibilities;
- poor procurement practices;
- poor application of program and project risk evaluation and risk management principles;
- lack of an integrated information system; and
- inadequate project management information.

These problems are recognized by the Department and are being addressed in the many ongoing change initiatives within DND. However, the introduction of new project management processes will require time to introduce new skills, training programs to operationalize the skills and a continuous program of cultural change to realize full implementation.

The Department has made a commitment to renewal

4.19 In December 1994 the Department embarked on a renewal program to explore innovative ways to acquire and maintain equipment. This was undertaken in response to the government's Program Review, budget reductions and the Defence White Paper, which directed the Department to have less infrastructure, fewer people, fewer command headquarters and more affordable equipment. Management renewal and business process re-engineering were the major strategies departmental management adopted to cope with budget reductions and improve the effectiveness and efficiency of operations. The management renewal program's principal objective is to allocate a higher percentage of available resources to operational forces and less to support

and administrative overhead. The major capital project acquisition process is one of the key areas targeted for reform under the program. The Department's overall strategic plan is to reform the acquisition process so that it incorporates best worldwide practices, identifies new acquisition concepts, reduces processes that drive requirements, seeks industry life-cycle support solutions, and develops training for the project management community. It now plans to have in place a plan of action by 1999 to implement a new acquisition process that could:

- ensure a highly effective and efficient project management capability;
- reduce the average cycle time of the process from its current average of 12 years to five years or less; and
- reduce by 50 percent from the April 1994 baseline the incremental project management personnel resources required for project management.

Changing the Way the Department Buys Equipment

Departmental acquisition renewal efforts

4.20 At the end of 1994, the Department established a Management, Command and Control re-engineering team to evaluate every activity in the Department, identifying those that could reasonably be eliminated and determining the best way of accomplishing those that remained. The capital acquisition process was one of the areas reviewed.

4.21 National Defence and Public Works and Government Services Canada (PWGSC) had set up a working group in June 1993 to study and evaluate the major capital projects process. The study had identified key areas for improvement, which became part of the basis for redesigning the key processes that guide the approval and conduct of major capital acquisition. From this, National Defence began its re-engineering studies. Their

The Department has begun to address internal management practices, but reforming capital acquisition processes involves several departments.

purpose was to renew all aspects of the materiel acquisition and support (MA&S) function and to develop a comprehensive plan for re-engineering the capital equipment acquisition process.

4.22 In February 1996, the re-engineering team completed its review of the major capital acquisition process and made recommendations dealing with both the Department's internal processes and government-wide processes affecting capital acquisitions.

4.23 To date, the Department has implemented the recommendations of the re-engineering team that were directed at its own internal project approval processes. However, the roles and responsibilities of other key players in the capital acquisition process, such as the Treasury Board Secretariat, Public Works and Government Services Canada and Industry Canada, are being examined as part of the government-wide acquisition reform initiative.

4.24 Departmental officials indicated that the primary focus of their reform efforts to date has been on support services and the procurement of supplies, spare parts, and services. They selected this area first because they believed it would provide the highest payoff for their efforts. The progress made thus far includes the adoption of innovative contracts for certain types of spare parts, and the establishment of several pilot projects.

4.25 The Department has recently shifted its focus to reforming the capital acquisition process. To this end, an oversight committee of officials from DND, PWGSC, Treasury Board Secretariat and Industry Canada has been established to harmonize and implement various procurement reform initiatives across government. National Defence officials told us that industry representatives have also been engaged to seek consensus on new approaches to government procurement. Through these

efforts, DND expects to achieve government-wide acceptance and adoption of DND renewal initiatives such as the use of pre-facilitated contracting, the commercialization of non-core activities, and longer-term partnering arrangements and contracts. The work of the oversight committee is expected to determine the extent of change to current government procurement policies and practices needed to fully exploit the benefits of new ways of doing business.

The Department needs to complete an implementation plan for re-engineering the capital acquisition process

4.26 In general, we found that the reform of the capital acquisition process is still in its early stages and progress in implementing change has been slow. This is understandable, given the complexity of the issues involved and the long-term nature of the problem. Also, because a major portion of the acquisition function remains outside the Department — particularly the contracting function — the Treasury Board Secretariat and Public Works and Government Services Canada also need to become involved in order to make the required changes. Departmental officials indicated that valuable lessons in acquisition reform have been learned from DND's participation in a bi-national capital acquisition project known as the Region and Sector Air Operations Centres Modernization (R/SAOC), a project with the United States Department of Defense. This \$93 million project is being managed in accordance with the U.S. Department's streamlined acquisition process and involves the modernization of the North American Aerospace Defense (NORAD) computers, communications equipment and infrastructure. This project and two others, the Materiel Acquisition and Support Information System (MASIS) project and the Light Utility Vehicle (LUV), have recently been designated as pilot projects in the government-wide capital acquisition reform initiative. Some acquisition reform concepts, such as the

purchase of available off-the-shelf equipment, have been tested on the Griffon helicopter project and the Maritime Coastal Defense Vessel project.

4.27 The Department has developed a plan for re-engineering the capital acquisition process, but it has not fully developed its implementation plan for the changes that have been proposed. The re-engineering plan called for the complete development of an implementation plan by the end of September 1997. The date has now been changed to March 1998.

4.28 Our audit findings described later in this chapter demonstrate that there is a need to continue the reform of the capital equipment acquisition process. Unless the Department takes action to correct the deficiencies reported in this chapter, the problems already reported will continue to affect future capital equipment acquisitions.

The human resource capacity to manage major projects is at risk

4.29 The Department is attempting to re-engineer its work processes in reaction to the forced downsizing of its headquarters and support staff. Downsizing was required because of budget cuts necessitated by the government's Program Review. Prior to 1994, the management of major equipment projects employed the equivalent of 1,415 full-time staff. The Department's year 2000 target for project management staff is 675 employees.

4.30 As we have already noted, the Department has not yet determined how it will re-engineer the equipment acquisition process. Although there is no assurance that the downsizing process will leave enough staff with the right skills to manage complex projects, the Department has reduction strategies in place to ensure that people with skills for which it anticipates a future need are not targeted under reduction activities. Also, as part of

the Materiel Acquisition and Supply re-engineering efforts, the Department is attempting to map out skills, knowledge and abilities generated as new re-engineered processes are introduced.

4.31 While the lack of planning creates a significant risk, the Department is aware of the problem. The Department has integrated human resource planning into its business planning process. It is also responding to emerging gaps with initiatives such as a civilian procurement officer development program. However, results of these initiatives will be evident only over time, and the efforts need to be sustained.

4.32 The Department should ensure that it has assessed the skills required to manage major equipment acquisitions, has a human resource plan in place, has its new recruitment and development programs operating and has information systems to support human resource management.

Department's response: The Department is pursuing a number of initiatives to address this recommendation. Specifically, the re-engineering of the Department's materiel acquisition and support processes allowed DND to clearly identify those skills, knowledge and abilities required for project management. The Department can now better determine where new recruitment and development programs are needed and refine internal training and development programs for existing staff. The DND Materiel Civilian/Military Information System currently supporting the Department's human resources planning and data base requirements will be replaced by PeopleSoft, which will better address the Department's human resource management needs.

Canadian industry has concerns about the Department's capital acquisition practices

4.33 As part of our audit, we held a one-day symposium with executives from major defence equipment contractors to

The Department does not know the full impact of reductions and process re-engineering on the skill requirements for major capital acquisition.

identify and discuss best practices in defence capital acquisition. The industry executives indicated that they were dissatisfied with the government's current process for buying major capital equipment. They suggested eliminating duplication of effort among the various federal departments involved in managing the acquisition process, having better-trained project staff, reducing turnover of federal project staff, adopting a less adversarial approach in the administration

of contracts, adopting a partnership approach between government and industry, reducing unnecessary paperwork, and reducing the use of military specifications. The industry representatives we spoke to also do business with the United States Department of Defense. They believed that National Defence's renewal efforts are not as far advanced as those of its American counterpart. They also indicated that they have noticed little or no change

THE UNITED STATES EXPERIENCE

THE UNITED STATES DEPARTMENT OF DEFENSE IS REPORTING SIGNIFICANT SAVINGS FROM RE-ENGINEERING ITS EQUIPMENT ACQUISITION PROCESS

Between 1991 and 1995 the US Department of Defense procurement budget was reduced by almost 40 percent. Recognizing that it could no longer afford to buy weapons systems as it had in the past, in 1994 the Department of Defense began broad-based changes to its acquisition and contracting processes.

Two of the areas that it is emphasizing are the requirements determination process – “what to buy” – and the acquisition process – “how to buy”.

In deciding “what to buy”, Defense's efforts are focussed on greater reliance on commercial products and processes, and more timely infusion of new technology into new or existing systems.

In considering “how to buy”, Defense has focussed on increasing teamwork and co-operation, encouraging risk management rather than risk avoidance, reducing reporting requirements, and reducing layers of review and oversight that add no value. It has also initiated a series of acquisition pilot projects to demonstrate that the use of commercial practices and processes can result in significant cost reductions in military equipment acquisition programs.

The projects were given regulatory relief from certain statutes, regulations, and internal Defense acquisition directives.

Defense officials have reported significant progress in implementing regulatory and statutory acquisition reform and achieving significant cost and schedule benefits – from 15 to 50 percent. The five pilot programs, which were selected in December 1994 and designated under the provisions of the *Federal Acquisition Streamlining Act* (FASA) of 1994, are the Joint Direct Attack Munitions (JDAM), Fire Support Combined Arms Tactical trainer (FSCATT), Joint Primary Aircraft Training Systems (JPATS), Commercial Derivation Engine (CDE) and the Non-Development Airlift Aircraft (NDAA).

Officials have reported significant gains in efficiencies for these pilot projects as a result of reducing the use of military standards, contract data requirements, the length and complexity of solicitations, and source selection cycle time.

The JDAM program, for example, projects a 34 percent reduction in development time and a unit cost saving of over 50 percent, with an associated total production cost avoidance of \$2.9 billion. The JDAM program office attributes these dramatic savings to the commercial-style environment created by FASA. The JDAM program manager capitalized on the “commercial environment” to procure proved

technology with reduced oversight (an average 85 percent reduction in in-plant oversight) and streamlined procurement documentation (29 data requirements and a two-page statement of work with only interface specifications and not military standards).

The Army's FSCATT program manager also reported significant cost and schedule benefits. Streamlined procurement efforts completely eliminated unique military standards, while reducing the number of data requirements from 56 to 7. In-house source selection hours were slashed by 30 percent. Development time and costs were reduced by 33 and 34 percent respectively.

JPATS acquisition reform initiatives made possible a 50 percent reduction in military standards and a 60 percent reduction in contract data requirements. These efforts resulted in a reported 12 percent reduction in development time and a 50 percent savings in program office staffing.

It should be noted that these results have not been independently validated by outside bodies such as the General Accounting Office (GAO). Nevertheless, the results of the pilots indicate that significant savings are possible through re-engineering the capital acquisition process.

in the way the Department acquires major capital equipment.

4.34 Officials noted that they had met with industry three times since June 1997 and had heard many of the same concerns expressed. They believe their re-engineering efforts will address many industry concerns, but noted that government-wide regulations and practices may be affected.

4.35 National Defence, in consultation with other key departments and agencies involved in the capital acquisition process — particularly Public Works and Government Services Canada, Industry Canada and Treasury Board Secretariat — should continue their efforts to:

- develop an implementation plan for re-engineering the capital acquisition process that clearly indicates the nature of the changes required, targets for performance improvement, and the approximate time frame for meeting the targets;
- select pilot projects to try out the re-engineered process;
- establish a set of meaningful performance measures to assess the performance of the revised process and determine whether it will achieve the desired results; and
- develop a human resources plan that identifies the types and quantities of skills needed to manage major capital projects.

Department's response: In the pursuit of procurement reform, the Department has developed a draft "Acquisition Reform Guide", which captures new acquisition concepts and is being developed into a detailed acquisition best practices implementation guide. This Guide will contribute to the development of the implementation plan for government-wide procurement reform, and its Materiel

Acquisition and Support Information System (MASIS) project is a key pilot related to the government's Benefits-Driven Procurement initiative. The target date for selection of other pilot projects and the supporting departmental implementation plan remains the end of April 1998.

The Department also believes that performance measurement is essential and is now incorporated in departmental planning. Public Works and Government Services Canada has made significant progress in developing performance measurement relating to acquisition project management that complements DND efforts to develop performance measures related to the materiel acquisition business. With respect to a human resources plan, as previously mentioned, DND has several activities in progress to formalize project management skills and develop project managers.

Requirements and Options Analysis

Why requirements and options analyses are important

4.36 The government's policy set out in the 1994 Defence White Paper reaffirms the need to maintain multi-purpose, combat-capable sea, land and air forces that will protect Canadians and project their interests and values abroad. The policy also states that affordable equipment will be purchased so our military will have the means to carry out their missions.

4.37 Determining requirements and analyzing the available options are important aspects of the major capital project acquisition process because they set the stage for acquiring affordable equipment. It is at this stage that trade-offs are made among factors such as quality, service, cost and socio-economic considerations. In complex acquisitions, a cost/benefit analysis may balance

Requirements and options analysis set the stage for acquiring affordable and appropriate equipment.

technical quality against such factors as initial and operating costs, economic life, service, maintenance and repair.

4.38 DND's capital equipment requirements can range from modernization of existing equipment through parts replacement to replacement of old equipment with new equipment designed to do the same job, to completely new families of equipment designed to do something that has never been done before.

4.39 We expected to find that all major capital equipment requirements would be based on continuing assessments of current and projected military capabilities, taking into account Canadian defence policy and changing military threats. We also expected that adequate tactical analysis would be conducted to define the type, quality and quantity of equipment required. Finally, we expected that options and alternatives that could fulfil those needs would be identified and their cost effectiveness analyzed before a specific solution was selected.

4.40 Our audit found that the 1994 White Paper allows officials a wide latitude to determine "how much is enough." It provides only general guidance by calling for multi-purpose, combat-capable forces that can fight "alongside the best, against the best." Officials told us that they interpreted this to mean capability anywhere from combat tasks, like peacekeeping, to war fighting such as the Korean War.

4.41 We found significant gaps in the analysis of requirements and options before purchase decisions were made. No project in our sample met our criteria entirely, and most met few criteria.

Military requirements were poorly assessed

4.42 We attempted to examine links among policy, threat assessments and the

tactical analyses used to justify each purchase.

4.43 Policy. For the most part, the projects we examined were linked to national policy requirements.

4.44 Threat assessments. We expected to find a threat assessment that would define the opponent against which a system might be used, and the weapons opponents might use. We expected to see a range of plausible threats developed in order to allow for uncertainty about where the Canadian Forces might be employed.

4.45 Several threat assessments for projects that were initiated during the Cold War era were not updated to reflect the post-Cold War threat climate. We noted that two of the six projects we audited did not carry out a formal reassessment of the threat.

4.46 The Electronic Support Training System project included a threat assessment in its 1988 Statement of Requirement. This assessment was very thorough in depicting the threat of enemy equipment and tactics at the time it was written. There was a comprehensive list of radar and communications "victim systems" that the project system must attempt to jam. However, the project will take a decade to field and the threat continues to evolve. The Department has recognized the evolution of the threat but maintains that risk and affordability concerns have prevented the project from delivering a more current training capability. Departmental officials state that the electronic system is software-based and therefore has the inherent flexibility to be adjusted to future needs.

4.47 Tactical analysis. The most significant gap we discovered in defining the military requirement was in tactical analysis. A tactical analysis is necessary to determine the optimum characteristics of equipment and to discover whether technological improvements provide actual combat value.

4.48 The \$1.2 billion Griffon helicopter project replaces three aircraft: two fleets of utility and one fleet of light observation helicopters. While it appears that there was a review of how a single aircraft could replace two types — utility and light observation — that have widely varying characteristics and capabilities, departmental officials could not produce a copy of it. The Statement of Capability Deficiency for the project set a pacing task of three simultaneous troop lifts from three locations to a position 500 kilometres forward in 24 hours. We found correspondence questioning the realism of this pacing task, and no substantiation for the distance and timing goals.

4.49 A study conducted in August 1992 — after the Department had selected the aircraft it wished to purchase but before Treasury Board approval on 8 September 1992 — indicated that the helicopter purchased could not meet the lift requirements for this task with the number of aircraft specified. In addition, analysts found that two fuel caches, not one, would be required to perform this task, putting in doubt the realism of the pacing requirement. The study also found that the load capacity of 3,100 pounds specified in the Statement of Requirements of the contract was short of the 5,000 pound minimum and 10,000 pound optimum capacity to transport an artillery gun or engineer equipment. However, the Department stated that the priority was tactical lift. Also, because of lift limitations, the aircraft selected would have to make 460 sorties from 24 helicopters to evacuate the casualties expected in a mid-intensity conflict and to provide logistic airlift. The study stated this was “an unrealistic proposition.” Departmental officials told us that the shortfall in lift capacity might be provided by allies. They also said that the requirements for casualty evacuation and logistic airlift were staff estimates from the Cold War era and may now be excessive, but offered no updated figures. We concluded that the tactical studies did

not adequately justify replacing two divergent aircraft types with one, and that they were concluded too late in the process to affect decision making. In addition, the studies called into question the suitability of the aircraft that was selected.

4.50 The Leopard Thermal Sight project is intended to improve the combat capability of Canada’s Leopard C1 tank by increasing the crew’s ability to see in the dark and in smoke. Tactical analyses conducted to define the Leopard tank upgrade did not support the decision to improve the night vision system alone. A major simulation war game conducted in 1993 concluded that even an improved Leopard C1 tank would not provide meaningful improvement to the army in a mid-intensity conflict. The study found that while the M1A1 Abrams tank would significantly increase the effectiveness of a battle group, an improved Leopard C1 tank would not. According to the study, “There was no significant difference in the entire battle group’s performance . . . [it] failed to withstand an attack or mount a successful assault.” The only other study by the Department was conducted by the manufacturer and thus cannot be considered independent. The objective of that study was to determine how the Leopard C1 tank should be upgraded to successfully engage the most likely type of enemy tank. The study found that a totally upgraded Leopard C1 could defeat the specified enemy tank in a one-on-one duel, but pointed out that this was a limited and unrealistic scenario; further studies that included anti-tank missiles and helicopter gunships were needed. In our opinion, the studies undertaken did not provide substantiation for the decision to upgrade the Leopard C1 night vision system.

4.51 Departmental officials told us that the first study — which examined a Canadian Forces battle group in a main force battle at the “high end” of mid-intensity conflict — did not reflect

The most significant gap we discovered in defining the military requirement was in tactical analysis.

the way they intend to employ Land Force combat units. They maintained that the Leopard C1 with a thermal sight would provide essential capability that would permit land forces to perform useful tasks in a broad spectrum of operations other than war and war fighting. They further said that they maintained close contact with NATO allies and that further formal studies were not necessary. They also pointed out that Belgium, Denmark and Greece have similarly upgraded their Leopard 1 tanks.

4.52 The tactical concept for the Coyote armoured reconnaissance vehicle was based on a number of studies, including the simulation that examined the Leopard C1 tank. The simulation study concluded that vehicles armoured to the same standard as the Coyote could not withstand the enemy fire they would encounter at the high end of mid-intensity combat without support of heavy forces. It concluded that this type of vehicle could not be considered for a “general purpose” combat force; forces so equipped should be considered light units with limited capabilities and be given only limited tasks. A battle group equipped with Coyote-type vehicles was regarded as likely to be suitable for peacekeeping but not necessarily for peace-restoring operations.

4.53 Once again, departmental officials disputed the validity of some aspects of this study. They said that the study scenario employed Canadian troops equipped with lightly armoured vehicles in a more demanding mission than would be appropriate, and the tactical employment of the Coyote vehicle required it to perform tasks for which it was not designed. In addition, heavier weapons systems such as attack helicopters, multiple launch rocket systems and close air support, which would be available from higher formations, were not included in the study. Officials told us they lacked the time to

conduct further studies after the purchase decision was made. They further pointed out that the Coyote vehicle is performing well and is highly regarded by Canada’s allies.

4.54 The Department determined the number of vehicles needed by referring to existing doctrine based on reconnaissance by soldiers with binoculars rather than complex sensors able to see almost 10 kilometres. The number of vehicles was then reduced as cost estimates increased. The number of vehicles needed was not determined on the basis of any tactical study. At the time of our audit, the Canadian Forces were still carrying out field trials to determine how to best employ this vehicle.

4.55 The key tactical considerations for the Eryx short-range anti-tank missile are that it be able to penetrate tank armour from all directions, engage targets at an effective range of up to 600 metres, and be fired from an enclosed space. Although these requirements were included in doctrine, we were unable to find adequate substantiation for the doctrine itself. In its internal documentation supporting the project, the Department claimed it had completed a study that indicated “unequivocally that only a guided system” had the accuracy it required. That study, however, was prefaced with comments recognizing that “a thorough examination of the subject was not possible”, there were “insufficient data on several subjects”, and “several aspects were not considered in detail.” The study makes no conclusions about guided or unguided missiles, nor does it substantiate any particular range requirement. The study calls into question the cost effectiveness of all man-portable anti-tank weapons. We found no substantiation of the validity of the criteria used to restrict the choice to a single missile, as presented to senior departmental officials. However, departmental officials told us that although appropriate analyses had been carried out, the documentation was no

longer available. The results of recent tests indicate that the Eryx's performance exceeds departmental expectations and satisfies their requirements.

4.56 Doctrine and additional studies, as well as most other documents supporting the project, assumed that a medium-range missile would also be fielded. However, the Department does not have a medium-range missile as it was considered to be unaffordable. Departmental officials told us that they have adapted their existing long-range missile for medium-range use instead of purchasing a new medium-range weapon. We did find adequate studies examining the number of firing posts required and the basic optimum ammunition load. But the Department did not study how the basic optimum load of six missiles per section could be carried in the field. At present, a section can transport only three missiles.

The Department relies heavily on professional judgment

4.57 Overall, officials expressed the opinion that their corporate professional judgment was an adequate basis for major procurement decisions. They pointed to the results achieved: the Eryx and the Coyote, for example, are highly regarded by some foreign forces. Nevertheless, we remain concerned that complex acquisitions are based so heavily on judgment, that studies performed are poorly matched to plans for employing the equipment, and that studies often do not support the selection of the equipment that is acquired.

Options analysis was inadequate

4.58 Once the military requirement has been clearly specified, the Department must identify ways of meeting it and the relative cost and effectiveness of each alternative. It is very important that all reasonable alternatives be identified and considered, or assessment of options will be an empty formality. We concluded that

only two of the six projects we examined had identified all reasonable options. None had conducted an adequate cost-effectiveness analysis.

4.59 In three cases — the Coyote vehicle, the Eryx missile and the Challenger aircraft acquired to carry Electronic Support Training equipment — only a single option was considered. In the case of the Coyote vehicle, the Assistant Deputy Minister (Materiel) and the Deputy Chief of the Defence Staff directed that the Light Armoured Vehicle (LAV 25) be purchased as the “threshold requirement.” No study of alternative vehicle types was undertaken. Since the direction specified the number of vehicles to be purchased, the possibility of filling part of the requirement with aircraft was not examined even though this was then, and is still, Canadian Forces doctrine. Departmental officials told us that some major components of the Coyote were acquired through a competitive process. They further stated that while satisfying the operational requirement is paramount, the government procurement process ensures that broader government and economic objectives are supported.

4.60 As we have already noted, the stated requirements for the short-range anti-tank missile reduced the choice to a single option. In its internal documentation supporting the project, the Department indicated in August 1987 that a study had demonstrated that only a guided missile could fill the requirement. Moreover, it said, a survey of “potential contenders” by Defence staffs had “confirmed” that there was only a single missile “in the Western world” capable of meeting this requirement. We found that the study did not support the Department's contention, and we could not find the survey on which this directed purchase was based.

4.61 A major component of the Electronic Support Training system is the aircraft used to carry the electronic simulators, jammers and countermeasures

Three of the six projects we reviewed had considered only a single option.

The Department relied on potential vendors for critical assessments and did not use life cycle costing.

equipment. The Challenger aircraft was selected without a competitive process. Our 1987 Report commented fully on that acquisition. This is the aircraft that will carry the electronic simulators, jammers and countermeasures equipment that the Electronic Support Training system comprises. The aircraft is not a direct component of the project.

4.62 In the three other projects we audited, options analyses had been conducted but we found them to be inadequate. The Griffon helicopter project did not adequately consider all options. A 1992 departmental cost/benefit study concluded that acquiring a single fleet of utility tactical transport helicopters would prove less costly than upgrading and maintaining a mixed fleet. While the study presented a graph that supported this conclusion, departmental project staff could not provide the source data used to create the graph. Because we were unable to verify the validity of the source data, we were unable to affirm the study's conclusions although they were generally supported by analyses presented to us by the project staff. While we did not undertake a full cost/benefit study, our own review of operations and maintenance costs based on the DND Cost Factors Manual and available data for the new fleet indicates that the new helicopter may cost 20 to 40 percent more to operate than the aircraft it replaces. We found no evidence that the Department consulted more than one company to explore the alternative of leasing aircraft. Ultimately, the aircraft were purchased from that company. Prior to the award of the contract, the manufacturer was asked to determine whether used helicopters were available, and it reported that it was highly unlikely sufficient aircraft could be found. Other new aircraft were excluded on the basis of higher initial capital costs, even though their larger size meant that fewer would have been required. Life cycle costs for other aircraft — which might have been lower — were not

considered. In short, the options analyses were too limited and relied in part on the potential vendor.

4.63 Departmental officials told us that developing a comprehensive options analysis for the Leopard Thermal Sight project had been precluded by affordability concerns. Options initially considered were to maintain the status quo, purchase a new tank, acquire a used tank, acquire a used armoured vehicle, or upgrade the Leopard C1. The Department determined that the thermal sight was the only affordable option. However, we could not find any studies to support this option as the best use of the army's money. The Department maintains that the addition of the thermal sight addressed the most critical deficiency in capability and was the most significant improvement possible with the limited funds available.

4.64 The options analysis in 1986 for the Electronic Support Training system mission suite had rejected the leasing of equipment, even though no actual solicitation to industry was made. By 1992 the United States Air Force, the United States Navy and the British Royal Navy and Royal Air Force had all opted for contracted-out service or had placed the equipment on ships, rather than on small aircraft that would have required extensive engineering and modification to accommodate it. A 1992 Canadian Forces review considered contracting, but concluded that there was no Canadian company able to provide the service and that acquiring the capability was the preferred option. However, no attempt was made to cost the contracting option. Finally, in considering various equipment options, the Department estimated the percentage of the training requirement each would meet. The preferred option was considered capable of meeting 75 percent of the total requirement. We could not determine how these percentages had been derived. Life cycle costing was conducted, but there was no supporting

documentation available that we could examine.

4.65 We are concerned about the weakness of nearly all the requirements and options studies that we examined. Particularly troubling are the number of directed purchases, the tendency to override results of tactical studies that challenge the accepted option and the conducting of tactical studies after decisions have been made.

There is a drift to low-end equipment performance

4.66 The ultimate goal of defence procurement is not to buy platforms — ships, vehicles and aircraft — but to build defence capability. While the number of platforms is important, vehicles that cannot do the job in combat do not represent good value for money. Our audit indicates that three of the six projects in our sample are resulting in the purchase of systems with low capability.

4.67 Chapter 3 showed that unless action is taken, the defence budget will continue to be overextended, and the force structure the Department is attempting to build may not be affordable at current levels of support efficiency. This appears to be a powerful contributing factor in the purchase of low-capability systems. It seems that the requirement so greatly exceeds the funds available that officials do not carry out rigorous analyses of requirements and options. Instead, they attempt to spread funds across as many requirements as possible, perhaps in the hope that at some point in the future the platforms it purchases can be outfitted. In the meantime, the Canadian Forces possess many platforms that cannot be fielded in mid-intensity conflict.

4.68 The following cases illustrate the problems that we found.

4.69 Utility tactical transport helicopter. The Griffon helicopter perhaps best illustrates the implications of not

enough money and inadequate analysis. Canadian Forces doctrine describes the role of tactical aviation as supporting land forces by providing aerial firepower, reconnaissance and mobility. Four types of helicopter are identified to carry out these missions — attack, light, utility and transport. Canada has never owned attack helicopters, but had a fleet composed of the other three types. Light and transport helicopters were eliminated in the early to mid-1990s to save money, leaving two types of utility aircraft. The Department's strategy was to fill the light, utility and transport requirements with a single aircraft because it believed that maintaining three different aircraft would be unaffordable. We did not find full substantiation for the assumption that money would thereby be saved.

4.70 The Department further elected to purchase a customized product based on a commercial-pattern helicopter rather than a military aircraft, with the rationale that acquiring the more expensive military aircraft would mean it could not afford the number of aircraft it needed.

4.71 Our audit focussed on how the Department determined its operational and performance requirements for a helicopter. We did not audit whether contract specifications were met. The helicopter it purchased has limitations in certain military roles, including the following:

- **Inadequate lift.** The aircraft statement of requirements called for the helicopter to be capable of carrying a 3,100-pound payload over a distance of at least 100 kilometres. This requirement was specified to meet the army's need to carry its new lightweight howitzer. Because the howitzer actually delivered is heavier, it can be carried only about 25 kilometres instead of the 100 kilometres expected. The Department's own study indicates that when troops are to be transported, one additional helicopter per squadron would be needed to deploy a company group simultaneously. In addition, the study points out that making

Budget limitations have resulted in the acquisition of equipment with low military capability.

Equipment cannot completely perform the missions that justified its purchase.

the number of daily sorties required to meet forecast rates of logistic lift and casualty evacuation would be unrealistic. As we have already noted, departmental officials state that these forecasts are based on staff estimates drawn from the Cold War era and may be overestimated.

- **Limited reconnaissance capability.** According to the Commander of Tactical Aviation Group 10 (10 TAG), "... a utility helicopter is not optimized for the conduct of reconnaissance missions, the direction and control of fire, and observation operations in a hostile environment. . . although if properly manned and equipped it could perform these tasks." Departmental officials indicate that some equipment has been acquired to enable the Griffon to conduct reconnaissance and perform operations in a hostile environment. They say there are plans to buy more equipment in the future that will enhance the reconnaissance capability of the aircraft.

- **Some defensive systems remain under development.** While adequate equipment for air crew protection appears to have been procured, some defensive equipment remains under development and would have to be acquired from allies in the event of sudden deployment. For instance, the radar warning receivers delivered initially are being replaced to procure a more technologically advanced product, combining the features of both radar and laser warning receivers. In the interim, departmental officials told us, a radar warning receiver could be obtained on short notice from allies. Departmental officials have said that the statement of requirements for an enhanced optic system for reconnaissance, surveillance and observation tasks needs to be refined, but no funds have been identified. At this point, no weapons have been provided other than a door gun. Departmental officials have not endorsed the need to further arm the helicopter.

- **Lack of communications assistance capability.** The Griffon has no radio rebroadcast capability. This feature is also expected to be delivered under a separate project, which is experiencing significant delays.

4.72 As a result of defensive systems and communication deficiencies, the Griffon at this juncture could provide only the capability required by Op Plan Sabre, the plan to meet the White Paper requirement to deploy an army brigade anywhere in the world in mid-intensity conflict, with assistance from allies.

4.73 Maritime Coastal Defence Vessel. The Maritime Coastal Defence Vessel represents an acquisition strategy similar to that for the Griffon helicopter — a platform built to civilian standards and fitted for, but lacking, the necessary mission kit to satisfy the remote mine hunting capability. When it requested approval of the project, the Department informed Treasury Board that it was following a design-to-cost strategy and that the full requirement — specifically, the remote mine hunting capability — was not affordable. The project received approval on that basis.

4.74 For a fleet of 12 ships, the Department will acquire four sets of route survey equipment to allow it to map the ocean bottom, two sets of mechanical minesweeping gear effective against only those types of mines tethered to the ocean bottom, and one bottom object inspection vehicle intended to be used for training purposes. This equipment could potentially have to be used to clear both Halifax and Esquimalt and would be able to remove only tethered mines. The vessels also lack bow thrusters to position the ship during mine hunting and clearance operations, as well as spare towfish required for route surveying. The bow thrusters will be essential if a remote mine hunting system is eventually acquired. Only three ships will have fully operational degaussing systems capable of reducing the magnetic signature of their

steel hulls. Departmental officials have informed us that bow thrusters and additional degaussing equipment were not initially provided by the project due to affordability trade-off decisions; some of this equipment may be provided later if the project has sufficient funds available at its completion.

4.75 At present, the Department cannot meet the goal of being able to clear a harbour within 48 hours. Despite the fact that this goal was the established priority in the mine countermeasures initial requirement, departmental officials told us that it is a long-term goal, one to which this project contributes. A remote mine hunting system is under development as a separate project but will not be available until well after the year 2000, by which time a significant portion of the ships' service life will be used up. In spite of these deficiencies, officials told us they believe that the project has attained its goal of providing a "credible" mine countermeasures capability. Departmental officials have informed us that "credible" should be interpreted to mean that "whatever limited capability was acquired must be effective, that is credible, within those limits."

4.76 The coastal defence vessel is also tasked with patrol and surveillance. For the most part, we found the vessel capable of performing these missions. We found that the original "essential" requirement for a data link system integral to the ship's command and control system was eliminated because it was not affordable. Officials now state that tactical data links are not essential for the types of operations planned for these vessels. They also lack passive electronic surveillance equipment to perform in the surveillance role, although it was previously regarded as "essential". This is an electro-optical vision capability to operate effectively in darkness and poor visibility. The capability was never acquired. The passive electronic surveillance capability

is partially met by Very High Frequency (VHF) direction-finding equipment.

4.77 Leopard C1 tank thermal sight.

The Department began by considering the total upgrade or complete replacement of the Leopard C1 tank. However, this would have cost over \$300 million. The total upgrade was described as necessary to meet the "minimum viable operational requirement". Affordability limitations required the reduction of the project to only the thermal sight. According to the sponsor's submission to the Program Control Board of the Department, "The constrained option [was] preferred solely because of cost factors." Departmental officials maintain that the addition of the thermal sight will enable the tank to perform some meaningful tasks in lower-end mid-intensity operations.

4.78 Eryx missile system. The Department believed that equipping all close combat field forces and the associated sustainment forces and infrastructure with the Eryx missile system would provide the optimum operational capability. This option would have required the purchase of 1,050 units at a total cost of \$436 million. However, this option was judged unaffordable. Consequently, the Department had to compromise and chose to purchase only 425 units at a cost of \$179 million, to equip close combat manoeuvre forces for infantry roles and the associated training infrastructure.

A stronger role for operations research is needed

4.79 Operations research is "a scientific method of providing executive departments with a quantitative basis for decisions regarding operations under their control." Operations research attempts to apply scientific methods to the solution of military problems. We found that the Department's operations research staff had conducted studies on all of the requirements in our six projects. These studies were well conceived,

professionally and independently executed and well documented. However, many of the studies we found were commissioned and completed *after* important decisions had been made, and either pointed to unsuspected problems or attempted to address problems that might have been avoided.

4.80 The Department's operations research staff constitutes a valuable and underused resource that could be better employed to improve capital acquisition decision making.

4.81 The Department should set minimum performance standards early in the requirements definition process, based on tactical and operations research studies. Failure to achieve these standards at any subsequent phase should immediately lead to a review of the project's viability.

Department's response: The Department's re-engineered acquisition approval process requires the development of a project Statement of Requirement (SOR). Supporting operational research analysis and scenario testing will play an increased role in defining these requirements. Once a project has begun, the process of matching operational requirements and the capability actually delivered continues as an iterative process through each successive phase of the project, during which project viability is assessed and, when warranted, challenged. Throughout a project, there are many opportunities for high-level scrutiny and decision making by senior departmental officials such as the Department's Senior Review and Program Management Boards. The ongoing development of performance measurement will also serve to enhance project oversight.

Risk Management

Why risk management is important

4.82 Risk management is a systematic approach to identifying, analyzing, and controlling areas or events that have a potential for causing unwanted change. It includes planning for risks, assessing risk areas, developing options for handling risk, monitoring risks to determine how they have changed, and documenting the overall program of risk management. Through such a systematic approach to risk, its probability of occurrence and the impact of risk areas or events are assessed and reduced to an acceptable level.

4.83 Unless a comprehensive risk management process is implemented, project risks may not be adequately identified and a suitable risk-handling plan developed and implemented. The consequences of inadequate or ineffective risk management can be cost increases, schedule slippage, and products or systems that do not meet performance goals and cannot be used effectively to perform military missions.

4.84 We expected that project staffs would follow departmental and Treasury Board policies for risk management in major capital projects. Policies require a thorough understanding of all the areas of risk in the project, including scope, complexity, skills and experience of the project team, the use of new technology, and the number of organizations involved. We expected to find project risk assessments that identified and quantified the risks of projects so that strategies could be developed to control them. Since risk factors can change over the course of a project, we expected to find risk assessments performed whenever a significant project change occurred and at scheduled times during a long project.

Several projects did not follow rigorous risk management processes

4.85 We found that only one of the six projects we examined fully met our expectations for a rigorous risk management process. A comprehensive risk assessment was conducted at the outset of the Eryx missile project, using defined and specified criteria. The results of the assessment were fully documented and updated. A risk management plan was incorporated into the prime contract and updated frequently. The plan used defined and specified criteria, and linked mitigation plans and actions to risk items.

4.86 Documentation of risk management for the other five projects was either incomplete or unavailable.

4.87 For example, project management staffs for the MCDV and Leopard thermal sight projects told us that risk assessments had been conducted at the outset of the projects, but they could provide no documentation other than the summary required for the submission to Treasury Board. Documentation of initial risk assessments for the EST and Griffon projects was incomplete. Since the initial risk assessment is the key starting point for effective risk management, we believe that inadequate documentation weakens subsequent risk management.

4.88 Departmental officials told us that all project management is risk management. In their view, the risks in the projects we examined were adequately managed through ongoing project management activities such as weekly or bi-weekly meetings of the project management office; monthly progress reports from the contractor and to senior departmental management; monthly, quarterly or semi-annual project progress review meetings; regular systems engineering, integrated logistics support or other working group meetings; and other mechanisms unique to the project. The project management teams view these

mechanisms as components of the risk management process.

4.89 While we agree that sensitivity to risks should be integrated into all management meetings and processes, good project management practices also require, in advance, the explicit identification, assessment and mitigation planning of problems that can be anticipated. Otherwise, project management can become no more than continually reactive crisis management. Failure to document risk assessments and mitigation activities against consistent measures also complicates internal and external communication of the status of risks and the steps taken to mitigate them.

Failure to fully assess risks reduces the effectiveness of project management

4.90 We noted instances where better risk assessment could have improved project management. Contingency allowances for the Electronic Support and Training Systems project is one example. Internal project documentation suggested that the project faced technical risks with a high probability of occurrence. When risks were reported to Treasury Board, the Department indicated that the risk of exceeding cost and schedule was a low probability, and the risk of failing to meet project performance expectations was a low to medium probability. The project was subsequently approved with a very low contingency fund, equal to only 2.7 percent of the project budget, or \$5.2 million.

4.91 If risks had been properly assessed and reported, it would have been apparent that contingency funds of 10 to 15 percent (\$19.1 million to \$28.7 million) were more appropriate, based on the Department's own guidance. Cost overruns totalling up to \$22 million on elements of the project have caused the project staff to rethink the approach to support. The original approach would probably have been manageable within the approved project funding if the

Documentation of risk management is deficient.

Integrated logistics support delays extended the Coyote project management office for two years at a cost of up to \$2.6 million.

All six project offices expect to meet or better their approved cost and performance objectives.

contingency provision had been based on a more realistic assessment of risks.

4.92 Formal risk management might also have resulted in more timely resolution of a problem with hangars encountered by the Griffon. Project funding was approved in late 1992 on the assumption that at least one third of the aircraft would be stored outside year-round, and that the rotor blades could be folded on a regular basis. The initial risk assessment documents we examined, which were incomplete, failed to identify such assumptions and their implications. Almost immediately after project approval, the operator of the aircraft, 10 Tactical Air Group, indicated that it wanted all the helicopters to be stored inside and questioned the feasibility of folding the blades. As a result of the lack of an assessed and agreed approach to solving the storage problem, additional hangars will not be complete until February 1998, causing at least some aircraft to be stored outside for more than one year. To construct the hangars, the project infrastructure budget was increased by \$9.9 million by transferring funds from other elements of the project, although without affecting project outcomes.

4.93 Another example is “integrated logistics support”. Integrated logistics support means that at the time of delivery of equipment to the field, the personnel to operate it should be trained, spares and ammunition should be available, and operator and technical publications and special tools and test equipment should already have been delivered to units. This requires complex planning and co-ordination, which, as we have reported in past audits, have proved to be a problem for the Department. Integrated logistics support is a risk area for all major capital projects, and calls for special attention.

4.94 We found that the Department had identified integrated logistics support

as a risk in four of the six projects audited (MCDV, Leopard thermal sight, Eryx and Griffon). Of these, the Griffon and MCDV projects subsequently experienced difficulties in this area.

4.95 The two projects (Coyote and EST) for which the Department did not identify logistics support as a risk also experienced difficulties in this area.

4.96 The impact of delays in the delivery of logistics support can be significant. In the case of the Coyote, the delay has resulted in extending the project management office’s mandate by two years, at a cost of up to \$2.6 million. The project office implemented measures to work around the difficulties. However, units have reported delays in becoming operationally ready due to shortages in support.

Projects are mostly meeting their performance and cost objectives

4.97 At the time of our audit, all six projects were expecting to meet their approved performance specifications, although some technical problems remained unresolved.

4.98 The Department expects that two projects will be completed under the Treasury Board-approved budget and the others on budget (see Exhibit 4.3).

4.99 Several projects, however, have experienced costs that might have been avoided if the projects had proceeded as planned, even though the projects remained within approved funding levels.

4.100 In the case of the Griffon project, some additional costs resulting from delays in delivery of the simulator were passed on to operational units. The simulator was delivered 17 months late, which required 403 Squadron to conduct 600 hours of training on actual helicopters. At an average operating cost of at least \$1,588 per flying hour, this incurred additional costs of \$952,800.

4.101 Delays in developing the radios for the Tactical Command Control and Communications System have meant that the Griffon and Coyote have been delivered fitted for older radios. The Griffon project spent \$2,218,000 to install old radios temporarily, while the Coyote project spent \$838,261. Additional costs will be incurred to install the new radios once they become available.

4.102 Extensions to project schedules require the expenditure of funds to maintain the project management offices for the additional time. We identified up to \$5 million in such costs for the Electronic Support and Training systems, Coyote and Eryx projects. The Electronic Support and Training systems project office has also noted that aircraft delivery slippage will result in additional costs for incremental staff and early and ongoing training of personnel, and a loss of opportunity for electronic warfare training. However, these costs have not been quantified.

Several projects experienced schedule slippages while preserving cost and performance objectives

4.103 When projects encounter difficulties, they will usually, with senior

management approval, extend the schedule rather than compromise overall cost and performance objectives. Compared with the Treasury Board-approved schedule, the Department expects four projects to deliver their last major equipment component late, while one will deliver early (see Exhibit 4.4).

4.104 In several cases, final equipment delivery dates understate delays in key project elements.

4.105 For the Electronic Support and Training systems project, the Challenger aircraft are to be delivered last, and were 22 months late at the time of our audit. Modified CT-133 aircraft and electronic warfare training pods were forecast to be delivered before the final Challenger, but were behind the Treasury Board-approved schedule for their delivery by 23 and 34 months respectively.

4.106 Late contracting for the thermal imager, due to technical difficulties in meeting the performance specification, has delayed final deliveries on the Eryx project. The thermal imagers were originally scheduled to be delivered before the last firing posts and missiles. However, thermal imager delivery is actually 53 months later than the Treasury Board-approved schedule, and has

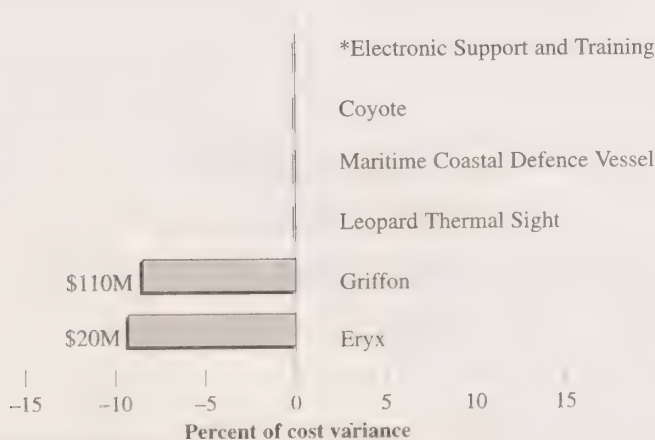


Exhibit 4.3

Project Cost Variance

* No additional funding has been approved for the project. However, the project has experienced overruns totalling \$22 million (10% of total approved funding levels) on major components. It will therefore be unable to implement a conventional in-service support posture within approved funding levels. As well, the contractor has submitted a claim for \$22.7 million in excess of the agreed contract fixed, firm price. At the time of our audit, the Department was reviewing the claim.

The Electronic Support and Training systems project's initial risk assessments overlooked several indicators of significant technical challenge.

therefore extended the overall project delivery schedule. Fielding of the system has been delayed up to 31 months due to a lack of training time available to units.

4.107 For the Coyote project, delivery of the final vehicle was forecast to be 10 months later than scheduled. However, project completion has been extended 24 months to complete the delivery of spares and maintenance manuals. These and other problems in integrated logistics support presented challenges and inconveniences as units put the vehicle into operation.

Risk management is an important part of effective project management

4.108 Many factors contribute to the successful outcome of capital projects. As the results of the Griffon project demonstrate, projects can meet or exceed their approved objectives even if their risk management processes are not explicit or well documented.

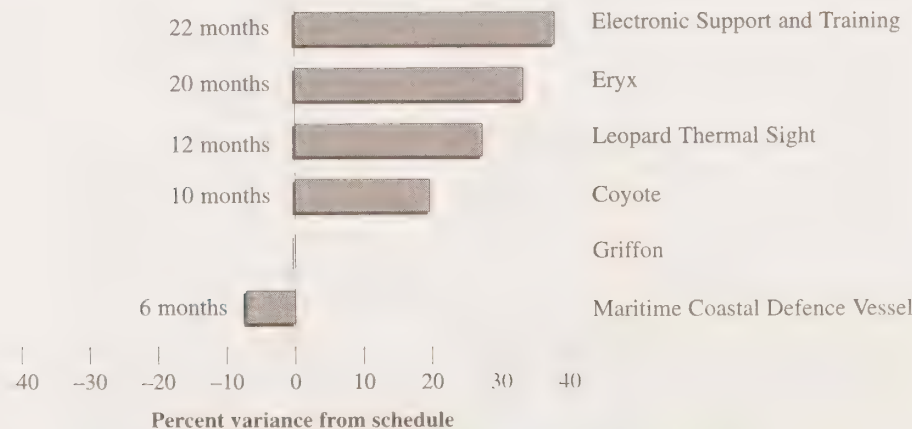
4.109 At the same time, we note the experience of the EST project, which did not use an explicit, documented risk management process. In spite of several indicators of significant technical challenge, none of the contractor's implementation proposals was ever formally assessed for risk, even though such assessment was required by the

proposal evaluation plan. The initial risk assessment had been conducted before the contractor submitted a compliant proposal, and documented only at a highly summarized level. Project documents prepared after the risk assessment noted that the project was "the most technologically ambitious modification project starting from ground zero [the Department has] undertaken to date", but the risk assessment was not updated. Subsequently, the project experienced substantial difficulties in meeting technical performance specifications and remaining within cost, and its approved schedule has slipped significantly.

4.110 We recognize that not all difficulties can be identified in advance. Nor can identifying and mitigating risks ensure that they are entirely avoided. However, we would expect management to take a more rigorous approach to risk assessment. Mitigation and management techniques could then be focussed on the problem areas. We note that since 1993 the Department has significantly strengthened its requirements for risk assessment and management, in concert with more rigorous Treasury Board policies.

4.111 The Department should ensure the adoption of a clear and consistent risk assessment process on all major capital projects.

Exhibit 4.4
Project Schedule Variance



Department's response: Since 1993, projects are required to include an Integrated risk management Plan and are subjected to a standard methodology and reporting system as part of the departmental risk management process. A risk analysis report is mandatory for approval of all projects over \$30 million and project staff are expected to report on a regular basis throughout the life of the project. Risk management is fundamental to effective project management and is essential to ensure successful achievement of project objectives.

Departmental risk assessments for Eryx were not consistent with the Treasury Board submission

4.112 Treasury Board must approve the acquisition phase of a project before it can proceed. This approval is based on information provided in a submission to the Board on project options, plans, cost, schedule and performance objectives, risks and management framework. At the time of approval of the six projects we examined, Treasury Board policy required that risks reported in project submissions be based on comprehensive assessments of all known risks and their potential impact.

4.113 When we compared the documented assessments for the Eryx project with the summary risk assessments in the Treasury Board submission, we found that the submission rated overall risks as lower than had been shown in departmental risk assessment documents.

4.114 We could find no documents explaining the change in risk assessment. We noted that the Department continued to manage the project at the higher risk level once it had received Treasury Board approval.

4.115 We are concerned that inconsistent risk assessments could lead to risk management attention and resources being devoted to the wrong areas. If the level or perception of risk changes during the approval process, this needs to be

documented and the revised levels reflected in subsequent assessments.

Testing and Evaluation

Why testing and evaluation are important

4.116 The primary role of a project office is to acquire equipment that can fulfil the operational tasks and missions of the Canadian Forces. It is incumbent on it to make sure that adequate tests and evaluations of equipment are carried out prior to purchase and during acquisition to confirm that the right type of equipment is being purchased.

4.117 This is especially significant where the role for which the equipment is acquired is significantly different from its intended or designed application. For example, selecting an aircraft with a commercial origin and certification as a basis for an acquisition, as was the case with the Griffon, will help to reduce developmental costs to DND and shorten the time frame for the acquisition process, which are worthwhile goals. However, this must be accompanied by efforts to ensure that the equipment will perform adequately under actual conditions. In a similar vein, the new combination of systems in a vessel based on commercial designs, as was the MCDV, can lead to unforeseen problems that will be uncovered only by operational testing under realistic conditions. The use of external agencies in the certification or acceptance testing of the base vehicle/vessel (such as the U.S. Federal Aviation Administration for the Griffon and Lloyd's Register of Ships for the MCDV) can help to ensure product quality and reduce the workload on DND staff.

4.118 Testing and evaluation are recognized as proved and effective risk management tools in major capital project acquisitions. They form a disciplined analytical activity that results in the accumulation of reliable knowledge to support risk management. This is

important because it enables project managers to ascertain whether contractors are providing equipment that meets the requirements specified in the contract and that also meets the needs of the users. Limitations in the quality or completeness of testing and evaluation can obscure or delay the recognition of problems with operational suitability. Our audit found that several serious equipment deficiencies that surfaced during the use of the equipment had not been previously identified by testing and evaluation.

4.119 We expected to find that all major capital projects would have an adequate testing and evaluation plan, structured to provide essential information to decision makers, assess the attainment of technical performance goals and determine whether equipment and systems are operationally effective and suitable. If the equipment or its application are developmental in any way, or differ from the original design, we would expect the equipment to be operationally tested, ideally before it is acquired or at least before being put into active service. Recent resource cutbacks in DND, such as the shutting down of the Land Engineering Test Establishment (LETE), and heavy workloads on the existing Aircraft Engineering Test Establishment (AETE) have affected the testing and evaluation function within project management offices.

The Department could make more effective use of testing and evaluation to manage risk

4.120 We found that the weaknesses we have noted in risk management are linked to the Department's inadequate use of testing and evaluation. Unlike defence organizations in other countries, the Department does not use the function as part of an overall strategy to manage project risks.

4.121 In the United States Department of Defense, which generally undertakes

projects of a more developmental nature, testing and evaluation as a risk management tool are an integral element of each phase in the acquisition life cycle. In contrast, DND's test and evaluation practices are not related to project phases or to the degree of risk associated with projects. Risk can be increased when equipment is used in ways that no other user has yet tried, when the operational envelope is extended or when even proved subsystems are combined in new ways to meet unique military or Canadian requirements.

4.122 In three of the projects we examined, the MCDV, Griffon and Coyote, operational testing was not carried out early enough to identify problems that now affect the entire fleet. As a result, each unit in the fleet will have to have its problems corrected through retrofit. As the MCDV was a purpose-built ship, testing before purchase was not feasible. However, the original contract for the MCDV allowed for a period of several months between the delivery of the first and second ships, which would have allowed for more extensive operational trials of the "first of class" vessel before follow-on vessels were built. But, because of unforeseen schedule delays, the gap between delivery of the first and second vessels was reduced. Despite the factory acceptance testing programs and sea trials in place prior to the vessel's acceptance, the Department did not discover major problems. These included the shutting down of main propulsion systems during operation (which limits the speed of the ship until it is rectified) and the malfunctioning of water purification units used to supply the ships with fresh water (which limits the range of operations possible before the supplies need to be replenished). The propulsion system problems have since been resolved under warranty.

4.123 Operational tests that could have been carried out on the Griffon to assess the aircraft's suitability for military use

were not done before acquisition. As a result, the Department is now discovering that the aircraft's capabilities are being stretched to their limits, particularly when the Griffon is used in applications that push its envelope, such as search and rescue operations. Problems not yet resolved include engine overtorques, and electrostatic shocks to personnel who ground the aircraft as it hovers.

4.124 Departmental guidance documents do not clearly define the types of acquisition and the most appropriate test and evaluation practices that apply to them. In certain types of projects that are fast-tracked or sole-sourced, such as the Griffon and Coyote projects, important test and evaluation steps are often not completed until after the acquisition decision has been made and after the equipment has begun active service. For example, prior to acquisition the Department did not test the new Griffon helicopter's ability to conduct military missions. After the aircraft was introduced into service it became apparent that its capability to perform certain military tasks is limited. One of the current problems is that search and rescue personnel and other personnel can suffer severe electrical shocks if they touch the ground while suspended from or stepping out of the helicopter. Such shocks are caused by the buildup of static electricity caused by the helicopter blades. With appropriate testing, this problem could have been identified and possibly solved earlier.

4.125 The Department should re-evaluate its strategy of purchasing commercial-pattern equipment without first subjecting it to trials for its military tasks.

Department's response: Procurement strategies for defence acquisitions will be based on a Commercial Off-the-Shelf (COTS) or Military Off-the-Shelf (MOTS) approach where that approach satisfies

the operational requirements of the Canadian Forces. The application of a COTS procurement strategy must be consistent and clear guidance on this matter is a key component of the Department's Acquisition Reform Guide. It is important to note, however, that it is not always possible to trial equipment (such as ships, for example) prior to its purchase.

4.126 The Department should adopt a test and evaluation approach on major capital projects that ensures that:

- test and evaluation are integrated with risk management;
- comprehensive test and evaluation plans encompassing the full project acquisition life cycle are developed for each major capital project and are updated as the project proceeds;
- equipment systems and components are tested to ensure that they are technically sound, based on the completion and full reporting of all technical evaluation trials; and
- equipment performance in all respects undergoes detailed assessment against current user requirements, early enough in the process to minimize the impact that any deficiencies found may have on the acquisition.

Department's response: The importance of test and evaluation (T&E) in the acquisition process is well recognized. The Department considers that the fundamental purpose of T&E is to manage and reduce technical risk. Clearly defined and developed systems requirements (operational and technical) ensure that the correct type of system/equipment is being acquired. Prior to contract, project offices ensure that the bidders' offers will meet the statement of requirements and that the contractor's proposed T&E program is adequate.

Project Monitoring and Reporting

Why project monitoring and reporting are important

4.127 Project monitoring and reporting are important elements of project management because they provide decision makers with information on the status of the cost, schedule and technical performance of projects. This enables them to know about emerging problems and to make decisions that keep projects on budget and on schedule.

4.128 We expected to find a framework for reporting on major capital projects, as well as clear guidance to project offices on the type of project reports to be produced, their content and frequency, and project performance indicators. We also expected to find an automated set of project reporting tools to facilitate the efficient and timely preparation of project status reports.

The Department lacks an adequate framework for reporting project performance

4.129 The Department's current approach to project reporting relies heavily on project officers to decide what type of information should be reported to higher levels of management.

4.130 Except for the Maritime Coastal Defence Vessel (MCDV) project, we could not find evidence that performance indicators have been established to support project monitoring and reporting. We noted that in March 1996, the Department directed project offices to adopt the Cost Schedule and Performance Management Standard for all major capital projects. Although some of the newer projects have begun to adopt this reporting standard, of the six projects we examined only the MCDV project had done so.

4.131 Based on our audit findings, we conclude that there is a risk that senior

managers in the acquisition chain of command may not regularly receive adequate project status information because there are no established standards and predefined project performance indicators that can be used as a basis for monitoring and reporting.

4.132 The Department should ensure that all major capital projects adhere to its direction to use a uniform project reporting system.

Department's response: Since 1996, all major capital projects follow a uniform cost, schedule and performance management standard. This standard was developed jointly by industry and government. This standardized reporting system is part of the broader project-reporting regime that the Department has instituted as outlined in departmental project management documents.

Conclusion

4.133 Our audit findings demonstrate that there is a need to continue the reform of the capital equipment acquisition process, particularly in the area of requirements and options analysis, risk management, test and evaluation, and project monitoring and reporting. Exhibit 4.5 summarizes our assessment of project management for the six projects we examined.

4.134 All six projects we examined are likely to meet their contract and cost performance objectives. Nevertheless, we are concerned about several of the management practices we observed:

- Management did not conduct adequate analyses to justify its spending decisions for most of the projects we examined, and options analyses were inadequate.
- Only one of six projects fully met our expectations for a rigorous risk management process.

- Although test and evaluation processes were satisfactory in most cases, for some of the projects involving commercially based designs the equipment was not tested under actual operating conditions until after it had been introduced into service.

- There are no established standards and predefined project performance indicators that can be used as a basis for project monitoring and reporting.

4.135 Unless the Department takes action to correct the deficiencies reported in this chapter, problems will continue to affect future capital equipment acquisitions.

Department's comment: The effective stewardship of resources is a primary management focus in DND. The Department continually assesses its acquisition decisions from the early analysis of requirements and options through every subsequent project phase. As well, DND is committed to continual

improvement of its overall acquisition process.

While DND welcomes the acknowledgement and encouragement of ongoing acquisition initiatives, the report does not fully portray these initiatives, or the progress made, into a broader reform roadmap which links other DND materiel management reforms and DND's contribution to multi-faceted government-wide reform initiatives. In consideration of its high cost, DND consciously decided to address operational support re-engineering first, and reform of acquisition second. We recognized that many operational support reforms would also apply to acquisition reform. Further, much work on acquisition reform was already in train. For instance, DND has already implemented reform in the approval phase of acquisition, the major cost driver in acquisition cycle times, and, similarly, in the project management portion of the acquisition process. An interdepartmental

Exhibit 4.5

Overall Assessment of Project Management against Criteria

	Griffon	Maritime Coastal Defence Vessel	Eryx	Electronic Support and Training System	Coyote	Leopard Thermal Sight
Requirements Determination	2	3	2	3	3	2
Options Analysis	2	3	1	2	1	2
Risk Management	2	3	4	2	3	3
Test and Evaluation	3	3	4	*	4	*
Project Monitoring and Reporting	2	3	2	2	2	2

Legend:

- 1— Not met
- 2— Mostly not met
- 3— Mostly met
- 4— Fully met

* Unable to assess because project has not yet reached this stage.

implementation plan, building on the complementary progress of DND and other departments in acquisition reform, is under way. Industry is engaged as a full partner and collectively we share many concerns that have been addressed in both DND and government-wide acquisition review.

Project risk is included in Treasury Board Submissions, which consider cost, performance, schedule and industrial benefit risk. DND also assesses additional types of risk including doctrinal, technical, and staffing risk, to name a few. Treasury Board's revised risk reporting procedure, which was introduced in 1995, better integrates this departmentally assessed risk. While risk assessment and test and evaluation are crucial to project management, not all equipment lends itself to operational testing prior to acquisition. It was not feasible, for instance, to test the coastal defence vessel (MCDV) before acquisition. However, the contractor corrected all deficiencies under warranty, which effectively achieved the same results as an enhanced test and evaluation program.

Acquisition contract decisions are based on a formal statement of military requirements and are taken in consonance

with the national strategies of many governments. Project managers must ensure that the Department receives exactly what it contracts for. It is important to distinguish between the "contracted" capability and other capabilities that either were not intended for a specific weapon system or were assessed as a lesser operational priority and for which DND found an acceptable operational solution. The Auditor General's report acknowledges that this "contracted" requirement will likely be met for all six of the projects assessed. For example, the Griffon helicopter capability for which the government contracted was evident in its UN peacekeeping deployment to Haiti and the support provided to domestic disaster relief operations.

With respect to performance reporting, DND does not share the auditors' conclusion that this is left to the discretion of individual project managers. Senior management is fully informed of project status through various project management mechanisms including monthly progress reports from contractors, formal Design Review meetings and regular updates to senior departmental Boards.



About the Audit

Objectives

The objective of this audit was to determine whether individual major capital projects were managed adequately, with particular emphasis on the following areas:

- requirements and options analysis;
- risk management;
- test and evaluation;
- project management, monitoring and control; and
- implementation of best practices in project management.

Scope

Our audit focussed on two management levels: the project office level, which manages individual major capital projects, and the base or unit level where operators use the equipment to carry out military tasks and operations.

We selected six major Crown projects (MCPs) out of a total 24 active MCPs (over \$100 million value). Our sample was selected on the basis of judgment and included projects from each of the three environments — navy, army and air force. The total value of the MCPs we reviewed is \$3.3 billion. Our criteria in selecting these projects were to obtain a tri-service sample with cumulative project expenditures of 80 percent or less that were typical of the kind of major equipment currently being acquired by DND. We selected the following projects: the Utility Tactical Transport Helicopter (Griffon), the Electronic Support and Training System, the Light Armoured Reconnaissance Vehicle (Coyote), the Short Range Anti-Armour Weapon (Heavy) (Eryx missile), Leopard Thermal Sight, and the Maritime Coastal Defence Vessel (MCDV). We recognize that these six projects may not be statistically representative of all DND major capital equipment projects. Their total value of \$3.3 billion, representing about 14 percent of the total value of approved capital projects over \$100 million in the Department's 1996–97 long-term equipment capital plan, makes them significant in their own right. The conclusions from this audit should be of interest to departmental officials involved in other major capital equipment projects.

For each of the six projects noted, we contacted the project office and discussed relevant acquisition issues. We obtained and reviewed available documentation pertaining to requirements and options analysis, risk management, test and evaluation, and project management and reporting. Finally, we conducted field visits and met with equipment users and operators to determine if the equipment met their operational needs.

We also met with foreign officials in the United States and with representatives of Canadian industry.

We used a results-based audit approach, with the primary focus on whether the Department exercised due diligence in the selection, acquisition and testing of equipment prior to putting it into operation and whether the operators of the equipment could adequately perform the tasks and missions for which it was acquired. In brief, we assessed whether DND's capital acquisition process delivers the type of equipment needed by the armed forces when they need it and at the best value for money.

Criteria

In assessing the MCP process, we used the audit criteria contained in the Office of the Auditor General's guide, *Auditing Capital Asset Projects*, as well as National Defence's publication, *Defence Program Management System (CFP-125)*. We also performed comparisons of National Defence's MCP process with capital procurement practices of other military organizations, such as the US Department of Defense and the UK Ministry of Defence. The detailed criteria we used are described in each section of the report, along with audit findings.

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Report of the
Auditor General
of Canada
to the House of Commons

Chapter 5
Revenue Canada, Department of Finance and
Department of Justice – Interdepartmental
Administration of the Income Tax System

April 1998

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of Canada
to the House of Commons**

Chapter 5

Revenue Canada, Department of Finance and
Department of Justice – Interdepartmental
Administration of the Income Tax System



April 1998

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Cat. No. FA1-1998/1-5E
ISBN 0-662-26793-1

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Chapter 5

**Revenue Canada,
Department of Finance and
Department of Justice**

Interdepartmental Administration of
the Income Tax System

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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Revenue Canada, Department of Finance and Department of Justice

Interdepartmental Administration of the Income Tax System

Main Points

5.1 Three departments play a key role in administering the income tax system. The Department of Finance is responsible for the formulation of tax policy and the introduction of new tax legislation. Revenue Canada oversees the administration of tax laws and the Department of Justice provides legal advisory services and litigation services to both Finance and Revenue Canada.

5.2 Efficient and effective relationships among Revenue Canada, the Department of Justice and the Department of Finance are essential for the smooth functioning of the income tax system. This audit was undertaken because our past work had raised some concerns about the management of risk to the tax base. Our current examination found that the departments have taken many important measures to improve their relationships. We have been told that the proposed change of Revenue Canada to a new Canada Customs and Revenue Agency will not affect their relationships.

5.3 An important aspect of managing the risk to the tax base is the identification and correction of legislative deficiencies. We found that Revenue Canada and the Department of Justice regularly bring deficiencies to the attention of the Department of Finance. However, the correction of legislative deficiencies is left to the discretion of the Department of Finance.

5.4 As all three departments are key players in managing the risks arising from legislative deficiencies, it is important that they all be involved in deciding which deficiency should be given priority.

5.5 The management of tax litigation risks has been improved. However, Revenue Canada and the Department of Justice need to strengthen the partnership arrangement for planning litigation needs and managing the risks.

5.6 Settlements of income tax disputes resolved through consent judgments have been made on a mix of law and facts. Revenue Canada should provide transparency in the settlement agreements it undertakes. As an example, United States income tax law provides public access to settlement agreements, with privacy protection of the taxpayer's identity.

Introduction

Relationships among Revenue Canada, the Department of Justice and the Department of Finance in administering the income tax system

5.7 Roles of each department.

Three departments play a key role in administering the income tax system. The Department of Finance (Finance) is responsible for the formulation of tax policy and the introduction of new tax legislation, Revenue Canada oversees the administration of tax laws and the Department of Justice (Justice) provides legal advisory services and litigation services to both Revenue Canada and Finance.

5.8 More specifically, the Department of Finance is responsible for undertaking analysis and providing policy advice on taxation matters at the federal level. It is also responsible for maintaining a tax system that raises revenue in a fair and efficient fashion and effectively targets incentives to meet government goals. In addition, Finance develops legislation and regulations necessary to implement federal tax measures, and it seeks to develop tax policies consistent with the government's objectives in other areas — social, cultural, economic, political, regional and federal-provincial.

5.9 Revenue Canada is responsible for operational and administrative policy related to the application of the tax legislation and for technical interpretations of the law. It collects a variety of taxes: income tax, goods and services tax, commodity taxes, excise duties and other levies.

5.10 This audit was undertaken because our past work had raised some concerns about the management of risk to the tax base. In our May 1996 chapter on income tax avoidance, we reported instances where legislative deficiencies were corrected promptly, while at the

same time there were instances of slow action. Our 1993 audit observation on the resource allowance income tax provisions pointed out poor risk assessment practices related to tax issues in dispute. In addition, parliamentarians have expressed a great deal of interest in the relationships among the departments and the process for identifying and dealing with deficiencies in tax law and managing the risk to the tax base.

5.11 Operational linkages. Exhibit 5.1 shows key operational linkages among the three departments. They interact in many ways — from finding the appropriate treatment of specific tax cases to updating tax legislation and administrative practices.

5.12 Revenue Canada is uniquely positioned to attest to the difficulties related to the administration of the *Income Tax Act* by virtue of its access to extensive data as well as through its interaction with 25 million Canadian businesses and individual taxpayers. It brings to the attention of the Department of Finance problems it detects in applying tax legislation. It also provides input to Finance on the administrative consequences of proposed legislative changes.

5.13 Revenue Canada and the Department of Justice interact through tax cases that require a legal opinion, through cases appealed to the Tax Court of Canada, the Federal Court of Appeal or the Supreme Court of Canada, through settlement proposals and through discussions about adverse court decisions.

5.14 It is important for the Department of Finance, Revenue Canada and the Department of Justice to communicate effectively. Systems need to be in place to permit Finance to learn about problems with the tax system as quickly as possible. It is also important for Revenue Canada and Justice to have an opportunity to comment on the compliance and administrative aspects of legislative proposals. This should ensure that

legislative drafters take into account the compliance and administrative aspects of the proposals.

5.15 The Policy and Legislation Branch of Revenue Canada acts as the focal point for co-ordination of Revenue Canada's input into the legislative agenda and as the liaison function with the Tax Policy Branch of Finance. The liaison function includes the participation in the development of tax policy and its impact on tax administration and the drafting of proposed amendments. The Tax Law Services Branch of Justice liaises with the Tax Counsel Division of Finance.

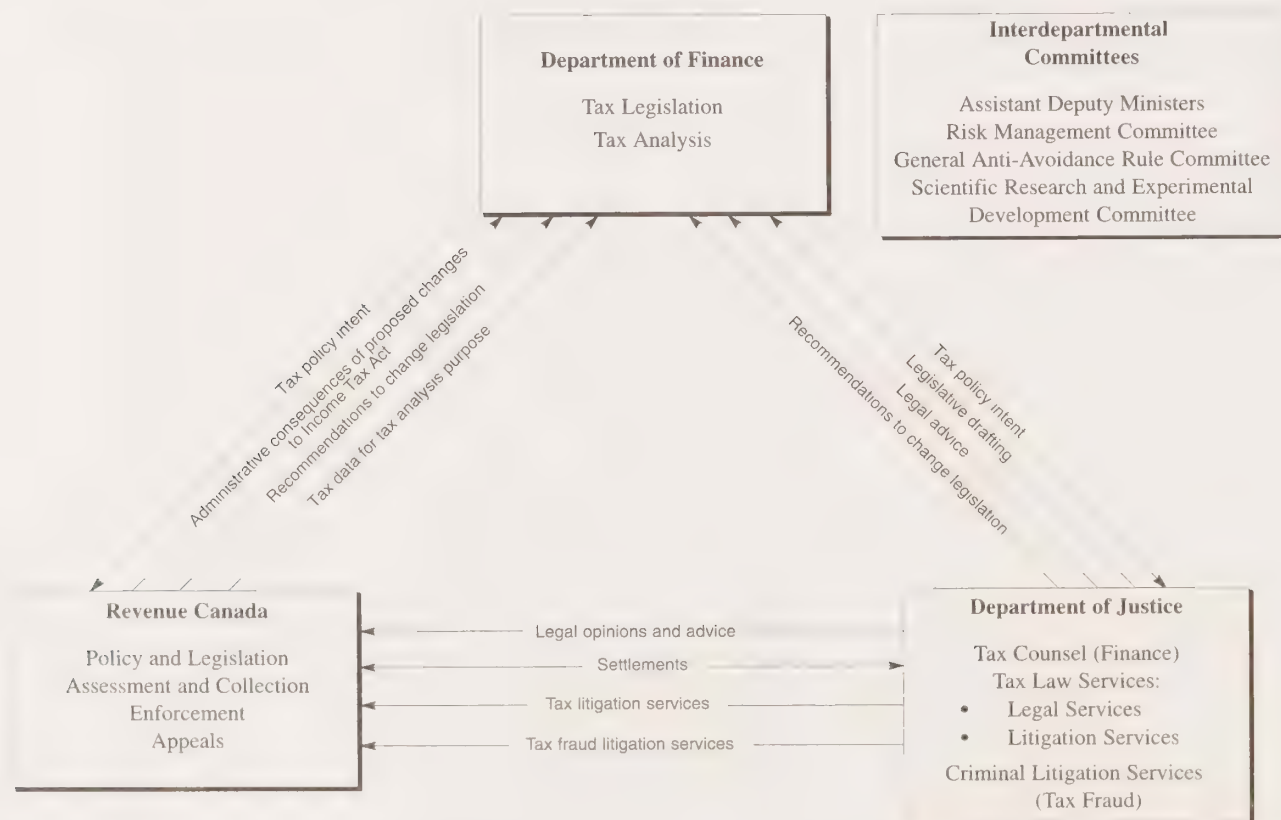
5.16 Interdepartmental committees provide a forum to facilitate the exchange of information and views on the

application of tax legislation and the administration of the tax system. These interdepartmental committees include the Risk Management Committee, the General Anti-Avoidance Rule (GAAR) Committee, the Scientific Research and Experimental Development (SR&ED) Committee and regular monthly meetings of assistant deputy ministers from each department. The drafting of technical amendments is done by the Legislative Review Committee, which is chaired by an official of the Tax Legislation Division of the Department of Finance. This committee includes officials from all three departments.

5.17 **New Canada Customs and Revenue Agency.** In the 1996 Budget, the government announced the proposed

Exhibit 5.1

Operational Linkages among Revenue Canada, Department of Finance and Department of Justice



creation of a new Canada Customs and Revenue Agency. It is expected that legislation creating this agency will be tabled early in the 1998–99 fiscal year. The new agency will remain a part of the Public Service of Canada and will have more flexibility in exercising administrative duties. It is our understanding that there is no intention to change the existing relationships of the three departments.

Focus of the audit

5.18 This audit focussed on the processes in place to bring problems with the administration of the income tax system to the attention of the Department of Finance in order to correct legislative deficiencies. It also focussed on the interdepartmental risk management processes in place to deal with the risks associated with income tax litigation. Further details on the audit are in **About the Audit** at the end of the chapter.

Observations and Recommendations

Managing the Risks Arising from Legislative Deficiencies

Tax issues are brought to the attention of the Department of Finance through a variety of channels

5.19 Revenue Canada. In 1995–96 and 1996–97, Revenue Canada brought about 200 tax issues to the attention of the Department of Finance. These issues originated mainly from the advance income tax ruling and audit processes. About 80 percent of them required Finance's views on whether specific transactions fell within the intent of tax policy, in order to issue advance income tax rulings and reassessments. The other 20 percent provided Finance with a specific recommendation to consider a legislative amendment.

5.20 Revenue Canada is also involved in the Budget process. For the 1997 Budget, it submitted seven proposals to change the tax legislation. Some of the Budget proposals related to areas where, in the past, Revenue Canada and Finance had agreed that amendments were needed.

5.21 To further the identification of problems in applying the tax legislation, rulings officers and experienced auditors develop issue papers that review recent advance income tax rulings issued in connection with certain types of transactions or recent assessments. These papers often identify potential legislative changes.

5.22 We examined the processes followed by Revenue Canada in developing these proposals and in determining whether a change in the legislation was needed. We found that Revenue Canada had implemented processes to strengthen its policy and legislation function.

5.23 Revenue Canada branches set up review mechanisms to analyze deficiencies brought to their attention by field auditors and appeals officers. The branches consider various corrective measures such as a change in the Department's assessing position, additional enforcement or a legislative change.

5.24 The Verification, Enforcement and Compliance Research Branch established a Legislation Unit to analyze the significance of legislative deficiencies detected by field auditors, to conduct research on the issues involved and to develop legislative proposals.

5.25 The Policy and Legislation Technical Sub-Committee reviews significant technical issues and other matters. It includes the Assistant Deputy Ministers of Verification, Enforcement and Compliance Research; Assessment and Collections; and Policy and Legislation as well as the Senior General

In 1995–96 and 1996–97, Revenue Canada brought about 200 tax issues to the attention of the Department of Finance.

The three departments
are involved in the tax
administration process
through their
participation in
interdepartmental
committees.

Counsel. The sub-committee recommends, among other things, which adverse court decisions should be appealed and if legislative amendments should be sought. The Appeals Branch has assigned an appeals officer to monitor legislative deficiencies identified in reviewing notices of objection and adverse court decisions.

5.26 The Department's various branches refer their legislative proposals to the Policy and Legislation Branch to ensure that the need to amend the legislation is further considered by senior officials of Revenue Canada. In order to bring the necessary rigor to legislative proposals received from individual program branches and to ensure that these proposals are thoroughly researched and take into consideration all corporate concerns, Revenue Canada established a committee in 1996 called the Policy and Legislation Committee. The mandate of this committee is to review significant legislative proposals put forward by Revenue Canada, horizontal program policy issues emanating from within Revenue Canada, major program policy issues led by a Revenue Canada branch, and policy issues originating in other government departments.

5.27 We examined how these new mechanisms interacted and whether there had been any improvements since their implementation. We found that better documented and researched legislative proposals had been submitted to the Department of Finance.

5.28 Department of Justice. The Department of Justice has recently strengthened its mechanism to develop legislative proposals for consideration by the Department of Finance. It now includes specific legislative proposals in its reporting letter to Revenue Canada on adverse decisions of the courts.

5.29 Interdepartmental committees. The Department of Finance is involved in

the tax administration process through its participation in interdepartmental committees. Finance officials are involved in dealing with specific tax avoidance transactions and in the application of the General Anti-Avoidance Rule through their participation in the GAAR Committee. On a weekly basis, this committee reviews tax avoidance schemes detected by Revenue Canada field auditors and advance income tax rulings officers. Finance also participates in the Scientific Research and Experimental Development Committee.

5.30 Finance officials participate in a three-department Risk Management Committee. On a quarterly basis, this committee reviews the status of cases involving important litigation risks.

5.31 Issues may also be brought to the attention of senior officials of each department. Every month or so, assistant deputy ministers meet to review and discuss issues of common interest to their organization. Issues discussed include tax policy, administrative matters and compliance burden concerns.

5.32 Informal contacts. There are numerous other ongoing meetings and informal contacts between officials of the three departments. These are important to the smooth functioning of the tax system. For example, the Tax Law Services Branch of the Department of Justice holds bi-weekly meetings with representatives from the tax counsel division of Finance, Revenue Canada Legal Services and Justice Tax Litigation Services. These meetings facilitate the identification and communication of legislative deficiencies to the Department of Finance through the tax counsel division.

Finance responds to Revenue Canada's requests for tax advice in a timely manner

5.33 We examined the responses provided by the Department of Finance to

Revenue Canada's requests for tax advice and legislative change.

5.34 In general, we found that the Department of Finance provided a response to Revenue Canada's requests for tax advice within a two-to-four week period. This allowed Revenue Canada to issue advance income tax rulings and reassessments.

Senior officials of all three departments need to be involved in the decision to correct legislative deficiencies

5.35 With respect to requests to amend the legislation, the record is not as clear. We have observed many instances where the Department of Finance moved quickly to introduce legislative changes in response to Revenue Canada's recommendation. These instances presented significant risks to the tax base — tax shelters, joint exploration corporations, and stop-loss rules (see Exhibit 5.2).

5.36 We have noted other situations where Revenue Canada reported regularly to the Department of Finance the difficulties it was having in administering certain provisions of the *Income Tax Act*, and Finance was slow to act. For example, Revenue Canada reported as early as 1988 instances of abuse of income tax provisions dealing with charitable donations. Changes in this area were announced in the 1997 Budget, nine years later.

5.37 Proposed changes are inventoried until a decision is made to proceed with an amendment. We noted that many proposed legislative changes had been in Finance's inventory for a number of years. For example, the inventory at June 1997 included over 400 items. About 67 percent of those items were more than four years old and were added to the inventory between 1986 and 1993.

5.38 The major reason given for the large number of outstanding requests for

amendments was the overburdened legislative agenda of the last Parliament. Ideally, Finance would like to introduce a technical amendment bill annually. The last one was introduced in April 1995. The 1995 technical bill, most of the 1997 Budget measures and many other changes introduced since 1995 had not been enacted as of March 1998. Finance officials were unwilling to consider commencing work on another technical bill until after the current draft legislation was enacted. They were also concerned about taxpayers' ability to absorb a large volume of changes in a relatively short period of time. They indicated to us that there was pressure from tax practitioners to not add to the current volume of outstanding draft legislation. As a result, there had been no review of the inventory since November 1994.

5.39 The decision to introduce legislative amendments before Parliament

We noted that many proposed legislative changes had been in Finance's inventory for a number of years.

Exhibit 5.2

Reporting and Correction of Legislative Deficiencies Related to Tax Shelters

1993	Revenue Canada identifies 26 legislative and administrative deficiencies from tax shelter study.
January 1994	Revenue Canada communicates 10 legislative proposals to Finance.
February 1994	1994 Budget announces two legislative changes to restrict the use of abusive tax shelters.
December 1994	Finance and Revenue Canada announce further measures to restrict abusive tax shelters.
February 1995	1995 Budget replaces film tax shelter mechanism for certified Canadian films with a tax credit.
March 1996	1996 Budget announces measures to restrict abusive tax shelters based on seismic data.
November 1996	A Notice of Ways and Means Motion proposes measures to further constrain tax shelters relying on a mismatch of income and expenses.
July 1997	Finance and Revenue Canada announce that tax shelters used to finance non-Canadian films will be replaced with a tax credit.
August 1997	Finance releases draft legislation intended to prevent abuses in computer software tax shelter property rules.

Finance acted promptly to correct legislative deficiencies brought to its attention by Revenue Canada. Legislation implementing announced corrective measures had not been enacted as of February 1998.

Unresolved legislative deficiencies can pose significant risks to the tax base.

depends on many factors, such as the need to consider other policy issues, the legislative agenda, the need to consult with stakeholders and priorities dictated by a Budget. However, Finance can stop tax leakage caused by a legislative deficiency by announcing its intention to amend the law through a Budget, a press release, or draft legislation.

5.40 Unresolved legislative deficiencies can pose significant risks to the tax base. However, the correction of legislative deficiencies and the time frame in which they are corrected is left to the discretion of the Department of Finance. As all three departments are key players in managing the risks arising from legislative deficiencies, it is important that they all be involved in deciding which issues should be given priority. This could be done through the interdepartmental committee of assistant deputy ministers.

5.41 The Department of Finance should regularly seek advice from the interdepartmental committee of assistant deputy ministers on which deficiencies should be given priority for correction.

Department of Finance's response: The Department is in general agreement with the conclusion that continued co-operation between the departments of Finance and Justice and Revenue Canada is essential to the smooth administration of the tax system. The officials of the Tax Policy Branch are committed to this goal.

Managing the Risks Resulting from the Dispute Resolution Process

Over 50,000 notices of objection are filed each year

5.42 Each year, taxpayers file 50,000 to 55,000 notices of objection with Revenue Canada. The objection process allows the taxpayer to submit additional

information and the Department to reconsider its original assessing position.

5.43 Currently, 550 employees assigned to the Appeals Branch of Revenue Canada in each of 37 Tax Services Offices (TSOs) and Taxation Centres do the review of these objections. In 1996–97, 29,000 objections were handled in the TSOs and 24,000 in the Taxation Centres.

5.44 Objections come from various Revenue Canada compliance programs. In 1996–97, there were 12,000 from field audit and 14,000 from the initial assessment process. The total value of taxes in dispute in these objections was reported by Revenue Canada to be over \$2 billion in that year.

5.45 Information provided by Revenue Canada shows that the outcome of the review of the objections in 1996–97 was as follows: taxes objected to confirmed - 34 percent; allowed in part - 19 percent; allowed in full - 27 percent. An additional 20 percent of objections were considered to be invalid or raised other concerns such as a request for a fairness review. Overall, Revenue Canada reported that 58 percent of the tax in dispute was retained after the objection stage (see Exhibit 5.3).

5.46 Following the completion of the objection stage, about 4,000 tax disputes proceed to the Tax Court or Litigation stage. Revenue Canada designated appeals officers and Justice tax litigators, located in several cities across Canada, handle tax litigation cases in the Tax Court of Canada. The Tax Court cases follow one of two procedures — Informal Procedure for cases where taxes in dispute are \$12,000 or under per year and General Procedure for cases where taxes in dispute are above \$12,000.

5.47 How each case proceeds and is ultimately disposed of varies between the two procedures of the Tax Court. In 1996–97, in the Informal Procedure, 31 percent of the cases were withdrawn by the taxpayer or dismissed, 20 percent

resulted in consent judgments, and 49 percent proceeded to trial. In the General Procedure, 44 percent were withdrawn or dismissed, 27 percent resulted in consent judgments and 29 percent proceeded to trial. Taxpayers were successful at trial, in whole or in part, about 30 percent of the time in the Informal Procedure and 33 percent of the time in the General Procedure. In total, there were about 1,300 Informal Procedure judgments and 400 General Procedure judgments resulting from trials (see Exhibit 5.4).

5.48 Following the judgment of the Tax Court, about 200 appeals are launched in the Federal Court of Appeal. Most of these are appeals from General Procedure decisions. Approximately 20 percent of Federal Court appeals are initiated by the Crown and 80 percent by the taxpayer.

5.49 Last year, the Federal Court disposed of 99 tax appeals by way of judgments. Revenue Canada was successful in 20 of the 31 appeals it initiated. Taxpayers were successful in 8 of the 66 appeals they initiated. There were two consent judgments. Another 33 cases were discontinued, 12 of these by the Crown. Finally, leave to appeal may be sought from the Supreme Court of

Canada, and the Court hears a small number of tax cases (about three to five) each year.

A risk management process is in place

5.50 As outlined in the government's response to the Seventh Report of the Public Accounts Committee in September 1995, Revenue Canada, Justice and Finance have adopted a strategy for the management of risk to the tax base resulting from the dispute resolution process.

5.51 The Assistant Director of Appeals at each Tax Services Office reviews the notices of objection and most of them are handled at the TSO. Some high-profile objections are instead dealt with at Headquarters. These include some income tax avoidance and large file audit appeals. Other cases require a review by Headquarters when an appeals officer proposes to revise an audit reassessment — for example where the audit has included a legal opinion.

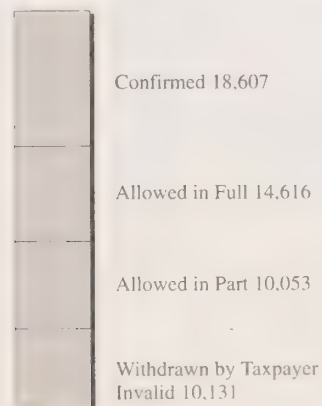
5.52 “Important issues list” created. As part of the risk management process, an “important issues list” has been created and is updated each quarter. The list indicates which cases are priority litigation cases, and which are test cases

Revenue Canada, Justice and Finance have adopted a strategy for the management of risk to the tax base resulting from the dispute resolution process.

Exhibit 5.3

Outcome of the Dispute Resolution Process, 1996–97 – Revenue Canada

53,407 objections reviewed



There was a reduction of tax assessed in 46 percent of objections.

Source: Revenue Canada

An important criterion for the assessment of risk at all steps in the dispute resolution process is the quantum of tax and interest at risk.

that represent issues concerning many other taxpayers. The following four reasons account for the importance of a case — quantum, tax policy, tax administration or social policy. The list also indicates the amount of tax at risk in these cases and the immediate cash impact of an outcome adverse to Revenue Canada. Currently, the list includes over 100 cases with a total estimated tax impact of over \$4 billion. The identification and communication of important issues alert the system to the risks involved and provide national consistency in the treatment of the issues.

5.53 Our audit confirmed that this risk management activity at the objection stage is being carried out as described in the 1995 strategy.

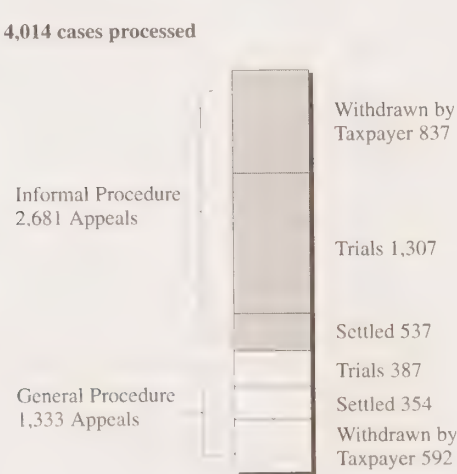
5.54 Risk management depends on reliable estimates of taxes in disputes. An important criterion for the assessment of risk at all steps in the dispute resolution process is the quantum of tax and interest at risk. This estimate is made for each notice of objection and is utilized in various aspects of the risk management process. Assistant directors of appeals have informed us that one weakness in the risk assessment strategy is the lack of a clear understanding of how tax at risk

should be determined and recorded by appeals officers.

5.55 Revenue Canada should provide better support to enable appeals officers to better estimate taxes in dispute at the objection stage.

Revenue Canada's response: The Appeals Branch remains fully committed to providing support to its appeals officers to enable them to estimate taxes in dispute at the objection stage. On 9 March 1998, a directive was issued to all appeals officers in Headquarters and the field on risk management and the information required to update the important issues list, which, among other things, indicates the amount of tax at risk in priority litigation cases (i.e. taxes in dispute). Included in the directive were guidelines for calculating the amounts of taxes in dispute and the interest at risk. In addition, co-ordinators from Headquarters have been identified to provide advice and assistance to appeals officers with the identification and compilation of risk management information pertaining to taxes in dispute. This assistance includes advice on calculating tax and interest amounts at risk. In addition, follow-up training for all appeals officers will be provided in this area during the upcoming fiscal year.

Exhibit 5.4
Outcome of the Dispute Resolution Process, 1996-97 – Tax Court of Canada



34 percent of appeals that proceeded in the Tax Court resulted in a settlement

Source: Revenue Canada

The Current Settlement Process

Settlements require documentation

5.56 At the Tax Court stage, the steps followed by Revenue Canada and Justice in handling litigation vary between the two procedures of the Court. However, in both cases, the appeal notices from taxpayers are all forwarded by the Tax Court to Revenue Canada Headquarters and are then assigned to a designated appeals officer in Headquarters or one of the Tax Service Offices. In the Informal Procedure cases, the Revenue Canada appeals officers draft the Notice of Reply to the appeal and file it with the Tax Court before handing the file over to Justice. In the General Procedure cases, the files are forwarded immediately from Revenue Canada to Justice and Justice lawyers draft the replies.

5.57 Our review of the files shows that Revenue Canada is involved in discussing and approving the litigation approach and settlement offers made and received by Justice at both the TSO and Headquarters levels. Our review also shows that the Revenue Canada designated appeals officers complete a consent judgment report on each settlement after it has been signed by a Tax Court judge. However, often Justice prepares no written reasons for the settlements in the Informal Procedure cases when it proposes a settlement to Revenue Canada. As settlements can result in significant tax changes, they all should be supported by proper documentation from Justice tax litigators.

5.58 The Department of Justice should complete a reporting letter for all consent judgments it recommends.

Department of Justice's response: As referred to below, Revenue and Justice have updated a Settlement Protocol that specifies the autonomy that Justice has in agreeing to out-of-court settlements. It was agreed between both departments that

it would be more efficient in "Court House Step" situations for Justice to be able either to reach a settlement without consulting Revenue or to reach a settlement after consulting with Revenue by telephone. It was also agreed with Revenue, taking into account resources constraints, that a reporting letter would not be required in respect of common issue informal procedure matters. However, taking into account your recommendation, we will alter our procedure to provide a brief reporting letter in the above-noted circumstances.

5.59 Recently, a Settlement Protocol was updated between Revenue Canada and Justice, which specifies the autonomy that Justice has in agreeing to settlements in both divisions of the Tax Court. As well, a Tax Law Services Litigation Strategy was introduced, which will identify and monitor risk at the litigation stage and will formally review General Procedure cases for the possibility of settlement at a number of stages in the litigation process.

5.60 Consent judgments are reached in 34 percent of the appeals that proceed in the Tax Court. This follows the objection stage where Revenue Canada reports that 63 percent of the cases have been settled. The principal reason given for settlement of additional cases at the litigation stage, especially with Informal Procedure cases, was new information provided by the taxpayer. Our review of consent files indicates this was the case. We observed that often information from taxpayers that would have been important to accurately complete the audit was not presented by the taxpayer until late in the litigation stage and then it resulted in a settlement being reached.

5.61 Each step in the dispute resolution process involves additional time and effort from Revenue Canada and Justice. Since Revenue Canada has committed to resolve disputes earlier, the timely receipt of taxpayer information is critical. Two recent examples of initiatives

Consent judgments are reached in 34 percent of the appeals that proceed in the Tax Court.

that encourage early resolution of tax disputes with corporate taxpayers are Section 231.6 of the *Income Tax Act*, which requires the early disclosure of foreign-based information, and the requirement that large corporate taxpayers pay one half the taxes in dispute and specify the reasons for their objection when filing an objection. Other non-legislative initiatives could be considered.

5.62 To facilitate earlier settlements, Revenue Canada should consider developing a broader strategy to promote the earlier disclosure of information by all taxpayers.

Revenue Canada's response: To reaffirm the role of the Appeals Branch in providing fair, timely and impartial dispute resolution, the Appeals Renewal Initiative was announced on 17 April 1997. One of the identified goals was the improved facilitation of communication between taxpayers and Revenue Canada. To that end, all relevant documents are now being made available to taxpayers and local access to government lawyers is being provided. A communication strategy is also being developed to encourage all taxpayers who file objections to provide the Department with full and complete details of their case. Additional communications training is being provided to appeals officers.

5.63 Our review of the consent judgment files, and discussions with Justice litigators, indicates that settlements have been made on a mix of law and facts. Our review also indicates that the documents that structure settlement agreements may take various forms such as Minutes of Settlement or letters from Justice Tax Law Services to Revenue Canada officials and do not form part of the consent judgment. United States tax law provides public access to settlement agreements, with privacy protection of the taxpayer's identity.

5.64 Revenue Canada should provide transparency in the settlements it undertakes.

Revenue Canada's response: In fiscal year 1997, over 90 percent of the settlements that were reached between taxpayers and Revenue Canada at the Tax Court level were pursuant to a consent judgment. When settlements are reached between taxpayers and Revenue Canada at the Tax Court level, pursuant to a consent judgment, documents are filed in Court outlining the settlement. A Tax Court judgment incorporating the terms of the consent is then issued after approval by the Court. Both the Tax Court judgment and the underlying consent documents are accessible to the public.

Administering Income Tax Litigation

Justice Tax Law Services needs to move into the electronic age

5.65 Tax Law Services of Justice is comprised of Tax Litigation Services and Legal Services. Tax Litigation Services does not have electronic access to the electronic database of legal opinions of the Justice Legal Services group located at Revenue Canada Headquarters. Although such electronic access has been discussed for several years, and would facilitate consistency in the litigation approach, it does not yet exist. Electronic access to these opinions by litigation lawyers would improve the integration of the legal advisory services and litigation services in Justice Tax Law Services. As well, access to these opinions and to Revenue Canada's Legislative Information Database could improve the efficiency of litigation preparation in Justice, as could the electronic transfer of documents between Justice and Revenue Canada.

5.66 The Department of Justice should develop the ability to electronically access legal opinions and other Revenue Canada interpretive

Electronic access to legal opinions by litigation lawyers would improve the integration of the legal advisory services and litigation services in Justice Tax Law Services.

**information and transfer documents
between it and Revenue Canada.**

Department of Justice's response: Since 1991, Justice has maintained a Tax Litigation System (TLS) that has recorded "tombstone data" with respect to all income tax appeals (except regional informal procedure appeals), including the assigned Justice office, the section of the statute and a description of the issues involved. For the last few months, Revenue Canada and Justice have been working toward the development of a secure Extranet site where fiscal information would be made available both to Revenue and to Justice lawyers of the Tax Law Services Branch. One of the key elements of the Extranet would be to provide access to the legal opinions of our Legal Services Unit. We are also looking at a way of providing a secure communication link either via this Extranet site or by the use of a software such as Entrust. Two joint working groups — one devoted to technological needs and the other to business needs — are leading the projects.

**Better information on the use of
litigation resources is needed**

5.67 There are about 120 lawyers and 70 other support persons currently involved in tax litigation work in Justice across Canada. Until recently, Justice Tax Litigation Services was not able to routinely account for the time required to complete individual cases or effectively track their progress.

5.68 A new computerized case management and resource-tracking system has been developed by Tax Law Services. It will track the progress of a case, from the Tax Court to the Federal Court and onward, and the resources devoted to it. The implementation of a new electronic system is critical to the efficient and effective management of the litigation process and provision of resource

management information but it has been proceeding slowly over the past year.

5.69 The Department of Justice should implement a computerized case management and resource-tracking system in all tax litigation offices in a timely manner.

Department of Justice's response: The Department of Justice is committed to the implementation of Caseview and Timewave in all tax litigation offices. In August 1997, the Group Head of the Edmonton Tax Litigation Section was dedicated to lead and complete this project in a timely manner.

5.70 Until recently, forecasting demands for litigation and other services provided by Justice Tax Litigation Services and communicating these to Justice has not been well handled by Revenue Canada. As described above, Justice has been unable to accurately report to Revenue on the use of resources assigned to litigation.

5.71 However, in the past year, Justice Tax Litigation Services has undertaken an in-depth review of its resources, and has been working with Revenue Canada to better identify Revenue's legal needs and meet those needs. For example, as part of the implementation of the Appeals Renewal Initiative, Revenue Canada has requested that Justice Tax Litigation Services provide legal assistance to the appeals officers who are handling objections in the Tax Services Offices. As of November 1997, the Department of Justice began providing legal advice to all appeals divisions. Seven additional lawyers have been placed in the regional Justice offices and Legal Services in Ottawa for this task. Revenue Canada is paying for the salaries. As well, Justice Tax Law Services has established national co-ordination teams, which include Revenue Canada, for particular tax litigation areas such as tax avoidance.

5.72 More could be done to foster a spirit of joint accountability for handling

**More could be done to
foster a spirit of joint
accountability for
handling tax litigation
and planning for
litigation resources.**

tax litigation and planning for litigation resources. To better forecast Justice workload and resource requirements regionally and nationally, it is important that Revenue Canada's regional and headquarters assistant deputy ministers recognize the demand for services provided by litigation lawyers in all aspects of *Income Tax Act* administration. Additionally, Tax Law Services must develop the capacity to fully participate in this joint planning and management process.

5.73 The partnership in planning litigation needs and managing the risks of litigation should be strengthened between the Appeals Branch of Revenue Canada and Justice Tax Law Services.

Revenue Canada's response: Significant steps have already been taken by the Appeals Branch of Revenue Canada and Justice to better plan and manage the risks of litigation. A joint conference was held in October of 1997 to forecast litigation needs and issues, and to plan joint training. A pilot project has been undertaken with respect to GST cases to develop a common reporting and tracking system. A joint session was held on 23 March 1998, to explore and assess the use of common information and technology. Bi-weekly meetings are now being held between the Assistant Deputy Attorney General for Tax Law Services and the Assistant Deputy Minister, Appeals Branch, to discuss litigation needs and issues of mutual concern.

Department of Justice's response: In addition to the comments made by Revenue Canada, we add that as part of the Early Case Management program that was developed by Justice (September 1997) in consultation with Revenue, meetings of Justice Group Heads and Revenue managers are scheduled in the departments' head offices and regional offices as needed to review issues arising in litigation files including settlement. These meetings focus on cases of

importance, in particular those where Justice and Revenue have not been able to arrive at a consensus.

Process for appeals to the Federal Court of Appeal needs to be more timely

5.74 Federal Court of Appeal cases are handled by Revenue Canada from its Headquarters Appeals operations in Ottawa. The Justice lawyers handling the cases are located in eight regional Justice offices.

5.75 As part of the risk management strategy, the decision to pursue an appeal to the Federal Court involves the three departments. After an adverse decision in the Tax Court, the lawyer who handled the litigation carries out a review of the reasons for the decision and, when desirable, a recommendation to appeal is made. When the case is on the "important issue list", the recommendation is forwarded to the Portfolio Litigation Co-ordinator in Ottawa. The Justice recommendation is then forwarded to the Assistant Deputy Minister of Revenue Canada, Appeals Branch, with a copy going to the Tax Counsel Division at Finance.

5.76 The Revenue Canada designated appeals officer responsible for the case also prepares an adverse decision report, which is reviewed by Revenue Canada Headquarters if an appeal is recommended. Officials from Justice and the Appeals Branch of Revenue Canada meet bi-weekly to review some of the more difficult cases. They may also seek the views of Finance. Last year, Revenue Canada Appeals Branch recommended 36 appeals to the Federal Court; 24 of these cases proceeded. Our review of files indicates that up to this point the process of reviewing adverse decisions was being completed in a timely manner.

5.77 The Crown's appeal to the Federal Court is filed within the required 30 days of the Tax Court judgment. The final decision to proceed with the appeal is taken by the Policy and Legislation

Technical Sub-Committee of Revenue Canada. We noted that the Assistant Deputy Attorney General for Tax Law Services does not attend these meetings.

5.78 The six months or so that pass between the initiation of an appeal and this confirmation introduce a significant delay. This delay may cause a conflict with the new Federal Court rules that are aimed at speeding up the court process. The Policy and Legislation Technical Sub-Committee approves over 90 percent of the appeals recommended to it.

5.79 This adverse decision process also makes recommendations to Finance when an appeal should be accompanied or replaced by a legislative amendment. In the past year, Justice has recommended amendments to Finance on five occasions in an adverse decision report. The Technical Sub-Committee of Revenue Canada has recommended a legislative amendment on 10 occasions in considering a decision to appeal.

5.80 **Revenue Canada's Policy and Legislation Technical Sub-Committee should act to confirm the Federal Court of Appeal cases in a timelier manner.**

Revenue Canada's response: Revenue Canada realizes that with the advent of the new Federal Court Rules, the timely consideration of adverse decisions is increasingly important. To improve the process, the Sub-Committee is now scheduled to meet every four weeks and instructions have been issued to all parties relevant to the decision-making process to provide analysis and recommendations in a timely matter. Together, these measures will ensure that recommendations to appeal to the Federal Court of Appeal are dealt with expeditiously.

Risk Management and the Appeals Renewal Initiative

Internal document advises to proceed with caution

5.81 In its response to the Public Accounts Committee in September 1995, the government stated that "more than 96 percent of the formal objections made by taxpayers are resolved by negotiation before they reach the stage of judicial hearing." The government also pointed out, "the Courts have made it clear that the settlement of fiscal disputes must be in accordance with the *Income tax Act* and may not be pure compromise that ignores the law."

5.82 Revenue Canada announced its Appeals Renewal Initiative (ARI) in April 1997. The principal objectives of the ARI are to facilitate earlier resolution of taxpayer disputes, to improve communication between taxpayers and Revenue Canada, and to improve transparency to the taxpayer by providing documents earlier that outline the Department's audit position. The Department has introduced a series of measures to implement the initiative.

5.83 An important aspect of the ARI was a commitment by Revenue Canada to consider ways to increase the timeliness and number of settlements.

5.84 In January 1998, Revenue Canada prepared a paper on Alternative Dispute Resolution (ADR) outlining possible ADR techniques (mediation, negotiation and arbitration) that could be used at the objections stage. This paper also contemplates amending the *Income Tax Act* to permit the Minister of National Revenue to make compromise settlements at the objections stage. As a next step, the Revenue Canada paper is to be discussed with Justice and Finance, and possible pilot testing of mediation has been recommended.

Delay in proceeding with the appeal to the Federal Court of Appeal may cause a conflict with the new Federal Court rules.

5.85 The paper includes several cautions for the proposed use of Alternative Dispute Resolution, including the possibility of disturbing a relatively well-functioning appeals system. We agree with these cautions. As well, a recent General Accounting Office report on the US Internal Revenue Service experience with the use of the ADR technique of mediation has indicated a relatively low uptake of this technique by taxpayers and a concern with the additional time consumed by the process.

5.86 In exploring the use of Alternative Dispute Resolution techniques, Revenue Canada should proceed slowly, with transparency and with appropriate risk assessment criteria.

Revenue Canada's response: Revenue Canada, together with the departments of Justice and Finance, has been examining the present constraints on the settlement of tax disputes, and has been exploring the possible use of Alternative Dispute Resolution (ADR) techniques such as mediation, negotiation and arbitration, in an effort to determine if the appeals process could be improved.

Revenue Canada is now discussing with the departments of Finance and Justice the possibility of pilot testing the mediation technique, in order to assess its efficacy and effectiveness as an Alternative Dispute Resolution technique. Revenue Canada recognizes entirely the Auditor General's concern that in moving to ADR techniques due regard be given to the transparency of the process and the potential risks involved. The Department will proceed in a careful and well-planned manner in consultation with all parties involved. To this end, before proceeding with any possible pilot project on mediation, or other ADR techniques, guidelines for all staff will be developed to delineate the cases appropriate for mediation. As well, consultations will take place both with Justice, Finance and

entities such as the Appeals Advisory Committee.

Conclusion

5.87 Upon completing our audit, we concluded:

- Revenue Canada and the Department of Justice regularly bring legislative deficiencies to the attention of the Department of Finance, and Revenue Canada has improved the quality of its proposals for legislative changes. However, the correction of legislative deficiencies and the time frame in which they are corrected is left to the discretion of the Department of Finance.
- As all three departments are key players in managing the risks arising from legislative deficiencies, it is important that they all be involved in deciding which deficiency should be given priority. This could be done through the interdepartmental committee of assistant deputy ministers.
- The management of tax litigation risks has been improved. However, more should be done.
- Settlements on income tax disputes resolved through consent judgments have been made on a mix of law and facts. Revenue Canada should provide more transparency in the settlements it undertakes.
- Revenue Canada and the Department of Justice need to strengthen the partnership arrangement for planning for litigation staff resources and Justice Tax Law Services has to move into the electronic age.
- To promote co-operative efforts in the areas recommended in this chapter and to facilitate the smooth administration of the tax system, efficient and effective relationships among Revenue Canada, the Department of Justice and the Department of Finance are essential. These three departments all play important roles in the administration of Canada's income tax system.



About the Audit

Objective

The objective of our audit was to assess the interdepartmental management processes in place for managing the risks to the tax base that are related to identified technical deficiencies in the *Income Tax Act* and that arise through the dispute resolution process.

Scope

Our examination was conducted in various offices of Revenue Canada and the departments of Finance and Justice and was limited to their activities. It consisted of interviewing staff and reviewing relevant systems and procedures, files and other documents. Our audit did not include a review of the Department of Finance's activities related to the development of tax policy or tax policy changes.

Criteria

There should be procedures in place to:

- consider the need for legislative changes to correct deficiencies;
- support the introduction, as early as possible, of draft amendments to correct identified legislative deficiencies;
- assess and monitor the risks of litigation;
- facilitate early and consistent settlements;
- provide transparency in settlement decisions; and
- plan for litigation staff resources.

Audit Team

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For more information, please contact Barry Elkin.

Report of the Auditor General of Canada to the House of Commons – 1998

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Report of the
**Auditor General
of Canada**
to the House of Commons

Chapter 6
Population Aging and Information for Parliament:
Understanding the Choices

April 1998



**Report of the
Auditor General
of Canada
to the House of Commons**

Chapter 6
Population Aging and Information for Parliament:
Understanding the Choices



April 1998

This April 1998 Report comprises 9 chapters and a Foreword and Main Points. In order to better meet clients' needs, the Report is available in a variety of formats. If you wish to obtain another format or other material, the Table of Contents and the order form are found at the end of this chapter.

© Minister of Public Works and Government Services Canada 1998
Cat. No. FA1-1998/1-6E
ISBN 0-662-26794-X

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Chapter 6

Population Aging and
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Population Aging and Information for Parliament: Understanding the Choices

Main Points

6.1 Canada today is sitting on a very favourable demographic structure, with a historically low ratio of youth and elderly to the working-age population. In the coming few decades, this situation will be radically transformed. By the second decade of the next century, when the leading edge of the baby boom generation reaches normal retirement age, the growth in Canada's elderly population will accelerate while that of the working-age population will slow to a crawl.

6.2 This demographic shift has the potential to affect government finances in a significant way. An aging population puts pressure on government spending through higher pension payments and increased demands for health care services. Also, unless there are significant changes in the patterns of work, this demographic change will reduce labour force growth dramatically, which in turn would slow down economic growth and, with that, the growth in government revenues. This combination could put enormous pressures on our public finances when the full impact of this demographic change is felt by the second decade of the next century, particularly if Canada's debt burden and tax levels remain high.

6.3 The government is well aware of these pressures; during consultations on reforming specific programs like the Canada Pension Plan, it provided detailed projections of the effects of demographic forces on CPP finances. This longer-term information not only helped inform public debate, but also motivated acceptance of the need for change. To a lesser extent, as government began discussing reforms to Old Age Security and the Guaranteed Income Supplement (the Seniors Benefit), it again provided longer-term projections of the financial impacts.

6.4 Yet what it has done to highlight the impact of demographics on the financial health of individual programs, it has failed to do for the financial health of the government as a whole. Consequently, parliamentarians are left to make annual financial decisions, many of which have lasting consequences, without a macro perspective — a summing up of the financial impacts that demographics can potentially have on the government's long-term financial health.

6.5 The importance of appropriate information to help parliamentarians understand the government's financial condition is clearly a responsibility and a theme on which we have reported over the last six years. This chapter, illustrating the feasibility of preparing such longer-term information and the significance of that information, is a continuum of the "Information for Parliament" chapters in our 1993 and 1995 Reports. The particular contribution of this chapter is its focus on the role of demographics in assessing the government's financial condition.

Introduction

6.6 For some years now, this Office has emphasized the importance of improved financial reporting for achieving full accountability — in particular, the limitations of the information contained in traditional financial statements and the importance to decision making and accountability of information about the medium to long term.

6.7 Our 1992 Report stated that without a long-term focus, there is no anchor for short-term policies. In 1993, we suggested a series of five indicators that would help taxpayers understand how their tax dollars were being used. We also suggested that it was not enough to look simply at the past, but that this kind of information should be projected forward to show the long-term impact of current fiscal policies on these indicators.

6.8 Our 1995 Report continued the theme of the need for a longer view by indicating that most of the discussions about controlling government finances had been focussed on deficit reduction and balanced budgets. The government had not addressed the larger question of how much debt it could sustain over the long haul, and how that would fit within an overall view of taxation, the role of government and its impact on the Canadian economy.

6.9 Annual budget balances, desirable as they may be, have taken on an aura of importance as the pre-eminent scorecard of government accountability, rather than being recognized for what they truly are — only one of many components that provide an assessment of the government's overall financial condition. Simply relying on current deficits and debt ratios to come down does not provide a complete picture of financial condition, nor does it adequately identify the trade-offs Canadians need to make or the intergenerational choices that must be considered.

6.10 The government's response to our reports has been generally positive. Starting in 1994, it began producing an Annual Financial Report that included the five financial indicators we had proposed in 1993. More recently, the government has begun to pay more attention publicly to the debt-to-GDP ratio. To date, however, it has not provided Parliament with any specific debt targets or fiscal projections beyond two years ahead. The government's view seems to be that there is no need for a longer-term perspective as long as the debt ratio continues to fall. In our view this is insufficient, particularly if equity between generations is a concern. As we know, Canadians are facing choices today. To make those choices — particularly any changes to spending, taxation or debt reduction — Canadians need information about the impact their choices can have on government programs and how the financial burden of those programs will be shared between present and future generations.

6.11 The Minister of Finance alluded to these issues in his remarks to the House of Commons Standing Committee on Finance at the opening of the pre-Budget consultation process last fall, but put forward no specific discussion of their potential financial impacts. By contrast, when the federal government engaged the public in consultations about changing the Canada Pension Plan (CPP), it went much further and provided specific financial information about the difficulties the CPP would face in the coming decades because of predictable demographic developments. That information was provided to convince the public of the intergenerational inequity in the then-current contribution/benefit schedule. In our view, the funding and intergenerational issues that motivated action on the CPP are relevant to other areas of government spending as well.

6.12 To a lesser extent, the government is engaged in a similar exercise in the reform of the Old Age

Budgetary decisions we take today can affect materially the fiscal choices available to future generations.

Simply relying on current deficits and debt ratios to come down does not provide a complete picture of government financial condition, nor does it adequately identify the intergenerational choices that must be considered.

Funding and intergenerational issues that motivated action on the CPP are equally relevant to many other areas of government spending.

Security and Guaranteed Income Supplement programs. Missing, however, is a macro perspective — a summing up of the financial impacts that demographics can potentially have on the government's long-term financial health, and the importance that annual fiscal decisions have with respect to that health.

Focus of the study

6.13 Canada's public finances have shown dramatic improvement over the past few years. The federal government's initial fiscal target of reducing the deficit to 3 percent of GDP by fiscal year 1996–97 was surpassed by a wide margin. The most recent federal budget estimated a balanced budget for 1997–98 and forecast a zero deficit over the next two years as well.

6.14 This prospect has given rise to intense public debate about budgetary choices. However, this debate seems to be taking place in a vacuum of information about Canada's demographic profile and its potential impact on our public finances.

6.15 The objectives of this study were twofold:

- to demonstrate the significance of a long-term perspective to a proper appreciation of the government's current

financial condition, with specific reference to the fiscal implications of current demographic trends; and

- to draw attention to the inadequacy of the information provided by the government to Parliament and the public about the implications of current demographic trends and their potential impact on current fiscal decisions.

6.16 Further details on the scope and conduct of the study can be found at the end of the chapter in **About the Study**.

Study Findings

Demographic Trends

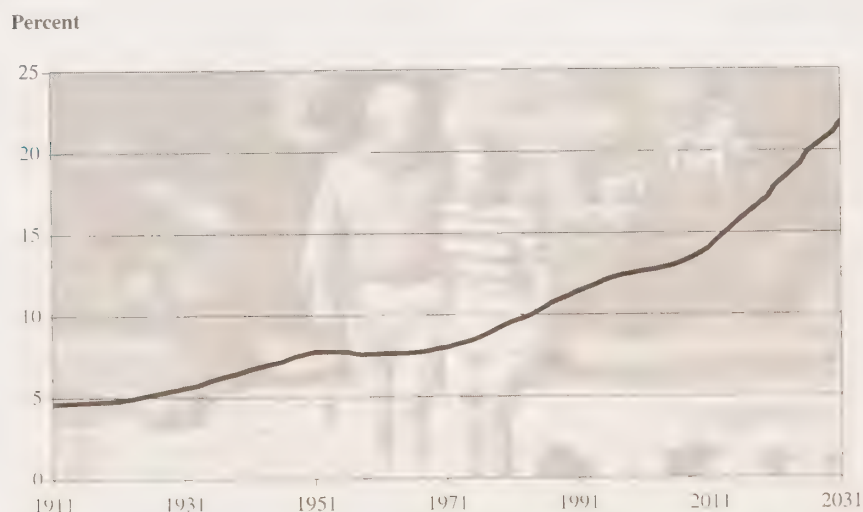
The aging of the population

6.17 Canada's population is aging, meaning that the proportion of the total population who are elderly is increasing. In a little more than a decade, as the early members of the huge "baby boom" generation begin reaching age 65, the increase in Canada's elderly population will accelerate.

6.18 Canada's population has been growing older through most of this century, brought on by falling fertility and mortality rates over time. As Exhibit 6.1 shows, there was a pause in this trend

Exhibit 6.1

Proportion of People Aged 65 and over in the Total Population, Canada, 1911 to 2031



between 1950 and 1970. That pause reflects the sharp increase in the number of births in the two decades following World War II.

6.19 From fewer than 250,000 per year during the 1930s and early 1940s, births soared to a yearly average of 425,000 between 1946 and 1965. Those born over this 20-year period represent the so-called baby boom generation. A baby "bust" followed, with births falling well below 400,000 a year over the past three decades, despite a much larger population base. The fertility rate — the lifetime number of births per woman — plummeted from over 3.5 during the baby boom years to 1.7 over the past two decades, a rate significantly lower than the replacement rate of 2.1, the rate needed to maintain the population at a constant level in the absence of net immigration. (For a discussion of the source and nature of the demographic projections, see Exhibit 6.2.)

6.20 The baby boomers will begin reaching normal retirement age by about 2010. Over the subsequent two decades, as successive cohorts of this generation join the ranks of the population aged 65 and over, the size of this age group will expand greatly.

6.21 Another factor contributing to this expansion is that people are living longer, the result of improvements in medical services and better living standards. In 1952, when Old Age Security was first introduced (with eligibility for benefits to begin at age 70),

a Canadian at birth was expected to live to 68.5 years. Today the average life expectancy is 78.5 years and is expected to grow to 80 years by 2016. In 1952, a 65-year-old Canadian was expected to live another 14 years on average. Today, life expectancy at 65 is over 18 years. In other words, over time, a growing proportion of Canadians are living long enough to qualify for social security benefits and on average they receive them for a longer time.

6.22 The onset of retirement of the baby boomers, together with gains in life expectancy, will result in rapid expansion of Canada's elderly population in the second and third decades of the next century. According to projections by Statistics Canada, the population 65 years and over will grow gradually from some 3.6 million today to five million by 2011 and then will soar to nine million by 2031 (see Exhibit 6.3). The rest of the population is also expected to grow over this period, but much more slowly. As a

In the decades beyond 2010, as successive cohorts of "baby boomers" join the ranks of the population aged 65 and over, the size of this age group will expand greatly.

Unless otherwise indicated, all demographic data in this section, including projected data, are taken from Statistics Canada sources.

Statistics Canada prepares four sets of population projections, using different assumptions concerning fertility, mortality and immigration. The projections reported here represent the medium-growth scenario. This assumes a fertility rate of 1.7, continuing increases in longevity but at a diminishing growth rate, and immigration of 250,000 a year.

Exhibit 6.2

Note on Population Projections

Exhibit 6.3

Population Trends – Selected Years

	Projections				
	1960	1976	1996	2011	2031
Population					
Total	17,870	23,517 *	29,964	35,420	41,216
Elderly (65 and older)	1,358	2,026	3,642	4,981	8,937
Elderly as a Proportion of Total Population	7.6	8.6	12.2	14.1	21.7

Over time, a growing proportion of Canadians are living long enough to qualify for social security benefits and on average they receive them for a longer time.

Over the next few decades, Canada's population of elderly will increase substantially and so will their average age.

result, the proportion of the total population who are elderly will almost double, from 12 percent today to 22 percent by 2031. The elderly dependency ratio — the ratio of the population 65 and over to the population aged 20 to 64 — is also projected to nearly double, from 20 percent today to over 38 percent by 2031.

6.23 The oldest among the elderly will experience the fastest growth in numbers. The population aged 80 and over will almost quadruple over the next 45 years, growing from about 820,000 today to some 3.1 million in 2041. Its proportion of the total population will swell from less than 3 percent today to over 7 percent, or from 23 to 33 percent of the elderly. In short, over the next few decades, Canada's population of elderly will increase substantially and so will their average age.

6.24 The actual demographic future may differ from the one projected, but not significantly. The people who will be retiring over the next few decades are already in the current population. Changes in fertility rates are not easily susceptible to policy influence. At any rate, changes in fertility will not have a significant impact on the labour force for at least two decades. Finally, immigration levels are the only policy lever that can affect the

population mix in the medium term. But its potential is limited, simply because even a doubling of current immigration levels would result in only a marginal decrease in the ratio of the elderly to the working-age population over the next few decades.

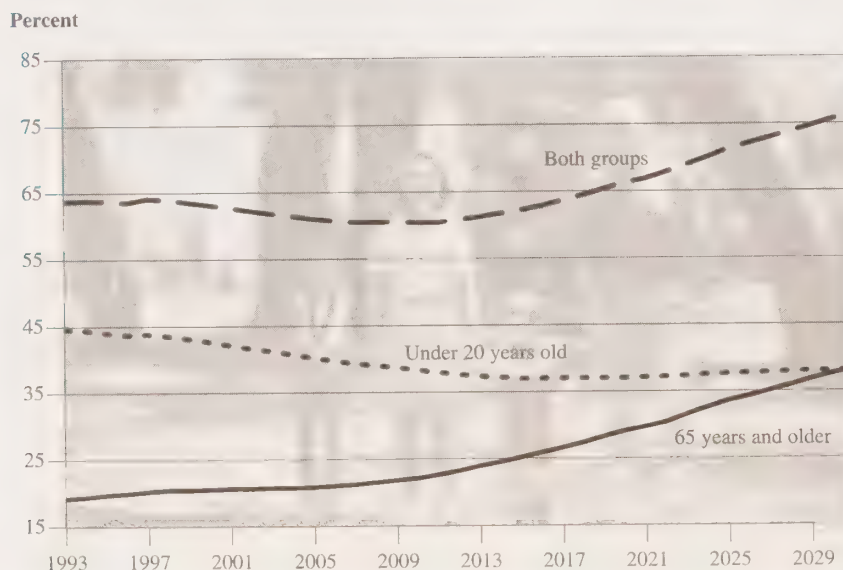
The role of a declining youth population

6.25 It may be argued that concentrating on the elderly exaggerates the impending demographic pressures because it ignores potential savings from a youth population that is declining in relation to the working-age population — the youth dependency ratio. As Exhibit 6.4 shows, this ratio declines gradually through most of the projection period, so that the total dependency ratio (youth plus elderly) does not rise as rapidly as the elderly ratio alone.

6.26 However, relying on these raw numbers as a basis for assessing the potential financial impact of the dependency ratio would be misleading because youth and the elderly do not represent equivalent demands on government spending. Estimates for Canada suggest that per capita spending on the elderly is two to three times greater than on the young.

Exhibit 6.4

Population Dependency Ratios 1993–1996 and Projections to 2031



6.27 Exhibit 6.5 shows elderly and youth dependency ratios, and ratios adjusted for the estimated differences in public spending on the young and the elderly. The table shows that on an expenditure-weighted basis, dependency ratios in the coming decades will be not only much higher than today but also higher than the high ratios of 30 to 40 years ago.

Demographic Changes and Economic Growth

6.28 How economies grow is not well understood. One can nevertheless draw meaningful inferences about the relationship between demographics and economic growth by concentrating on the two basic factors contributing to output — namely, capital and labour. An aging population can affect economic growth through the amount that the nation saves, and therefore invests, and through changes in labour force growth.

Demographic developments will tend to depress domestic savings

6.29 Total savings in the economy are made up of savings by the private sector and by governments. Demographic shifts can affect private as well as public saving rates.

6.30 Among individuals, a strong reason for saving is to smooth consumption over time. Typically, people consume a higher proportion of their income in their early years (when incomes are low), less during middle age, and then more again during retirement. The pattern of saving is the reverse of the consumption pattern.

6.31 This pattern of consumption/saving suggests that baby boomers, who are now in their peak earning years, are also in their peak saving years. Other things being equal, then, personal savings may fall over the next few decades as this generation ages and leaves the work force for retirement. By how much savings may fall is difficult to say, because we lack good estimates of the responsiveness of saving to changes in life circumstances.

6.32 Government saving is also negatively affected by the population's aging. An aging population brings on pressures for governments to spend more, which is tantamount to saving less. The result is that Canada could experience a significant drop in total savings (private and government combined) during the second and third decades of the next century.

6.33 This prospect's relevance to government finances stems from the effect that savings have on economic growth and

	Projections				
	1960	1976	1996	2011	2031
Dependency Ratio ¹					
Elderly	14.9	15.4	19.9	22.6	38.2
Youth	81.3	63.8	43.7	37.9	38.1
Total	96.2	79.2	63.6	60.5	76.3
Expenditure Ratio ²					
Elderly	25.4	26.2	33.7	41.6	70.5
Youth	55.5	43.5	29.8	23.3	23.4
Total	80.9	69.7	63.5	64.9	93.9

Population of age group as a percentage of the population 20 to 64 years old

² Dependency ratios weighted by relative public spending on old vs young, using a factor of 2.5:1

Exhibit 6.5

Dependency Ratios, Crude and
Expenditure-Adjusted –
Selected Years

By the second and third decades of the next century, as baby boomers leave the work force for retirement, labour force growth will slow to a near standstill.

As labour force growth weakens, so will economic growth, unless productivity improvements offset the declines in employment growth.

therefore on government revenue growth as well. Saving is the means to investment. Low rates of saving imply either low rates of domestic investment or higher foreign indebtedness, if we borrow abroad to keep investment levels high. Lower investment means lower capital per worker and hence lower productivity and income growth. Higher indebtedness to foreigners means that a higher proportion of incomes generated domestically accrues to non-residents in the form of interest or dividend payments. In either case, a reduction in the level of our domestic saving would leave future Canadians economically less well-off and the tax base available to Canadian governments correspondingly smaller.

Growth in labour force will slow sharply in coming decades

6.34 The number of people in the labour force depends on two factors: the size of the working-age population and the proportion of that population that is either working or looking for work — that is, the labour force participation rate. Over the next few decades, labour force growth is expected to slow down because of changes in both of these factors.

6.35 According to Statistics Canada projections, the annual increase in Canada's working-age population will fall from an average rate of 1.6 percent over the past 20 years to less than 1 percent during the second and third decades of the next century. Growth in the labour force will decline even more because the labour

force participation rates are also expected to fall.

6.36 The anticipated reduction in labour force participation rates is also due to demographic factors. In the coming decades, an increasing proportion of the working-age population will fall within older age groups, which are characterized by lower participation rates. In particular, the baby boom generation is currently at its peak participation age (30 to 50 years old). As it grows older and its attachment to the labour force weakens, it will tend to pull down overall participation rates. Of course, factors other than demographics — factors such as wealth and income levels, social policies and attitudes — also affect labour force participation rates. Our projections do not reflect such factors, because their long-term impact is more difficult to assess than that of demographics.

6.37 Exhibit 6.6 shows historic and projected labour force growth rates over specific periods to the year 2031. The anticipated reduction in participation rates together with a slowdown in the growth of the source population result in a marked projected decrease in labour force growth over the next decade. By the second and third decades of the next century, as baby boomers leave the work force for retirement, labour force growth will slow to a near standstill.

6.38 This labour market outlook has a direct effect on the expected rate of economic growth. Growth consists essentially of the sum of growth in

Exhibit 6.6

Labour Force Trends

	Projections			
	1976–96	1996–2011	2011–2021	2021–2031
(average growth rates – %)				
Source Population	1.5	1.4	1.1	0.7
Participation Rate	65.2	62.1	58.8	55.8
Labour Force	1.8	1.1	0.4	0.2

employment and in productivity, or output per person employed. As labour force growth weakens, therefore, so will economic growth unless productivity improvements offset the declines in employment growth.

6.39 Over the past 20 years, real GDP growth in Canada has averaged 2.6 percent a year. Productivity improvements accounted for approximately one third of this growth and employment growth for two thirds. Given the labour force projections we have outlined here, the contribution from employment growth will fall sharply in the years ahead. During the second and third decades of the next century, economic growth will be confined to essentially the rate of growth in productivity. If the productivity performance over these decades parallels that recorded over the past two decades, GDP growth will slow to little over one percent a year. To attain the average growth rate recorded since the mid-1970s, the rate of productivity growth will have to more than double.

Higher rates of productivity growth are possible but not assured

6.40 Increases in labour productivity can come about in essentially two ways: increases in efficiency through the way labour and capital are combined (economists call this Total Factor Productivity — TFP), and increases in the amount of capital per worker. Over the past two decades, gains in TFP have been weak, despite technological innovations and structural changes in Canada's economy like tax reform, financial services deregulation and freer trade.

6.41 There are some who believe that this trend may change because of the revolution in information technology. There are also those who argue that the productivity effects of information technology are likely to remain small, either because the effects of computers are in fact relatively small or because they are

not captured by official output data — for example, the benefits attached to Internet or banking machine access. If this view is correct, information technology may not show a large payoff in measured GDP growth.

6.42 Labour productivity could improve even without improvements in overall efficiency, if labour had more capital to work with. But with the potentially adverse impact of an aging population on saving rates, and consequently on capital, most long-range forecasts of the Canadian economy in fact show a declining growth rate for the capital stock in the coming decades.

6.43 In light of these considerations, significant increases in productivity growth are not assured. For the fiscal projections reported later in this chapter, we assume labour productivity will increase at an annual rate of one percent, only marginally higher than the average productivity growth experienced since the mid-1970s.

6.44 As already indicated, economic growth is basically the sum of growth in productivity and in the labour force. Then, if the rate of productivity growth remains roughly constant and there is a marked slowdown in labour force growth over the next few decades, this implies that economic growth will also decline markedly (see Exhibit 6.7).

Demographic Changes and Government Spending

6.45 Changes in the age structure of a population probably affect every category of government spending to some degree. Three areas of spending, however, are particularly sensitive to demographic shifts: social security, health care and education. Because the share of the school-age population does not change over the projection period enough to significantly affect government spending, we considered the effect of aging only on spending for social security and health

To attain the average growth in GDP since the mid-1970s, the rate of productivity growth for the next 30 years will have to more than double.

By 2031, Old Age
Security outlays are
projected to rise to
2.9 percent of GDP
compared with
2.0 percent today.

care. While not all the elderly will be dependent on publicly funded pensions and services, many of them will be, putting pressure on government spending for social security and health care. In this section we illustrate that under current policies, government spending in these two areas will grow considerably faster than GDP in the coming decades, even with fairly conservative assumptions concerning future increases in health costs.

Government spending in social security will accelerate

6.46 Canada's retirement system is described briefly in Exhibit 6.8. The public components of that system are financed essentially on a pay-as-you-go basis. In other words, benefits to existing beneficiaries are paid for by levies on the employment earnings of current workers (in the case of the Canada/Quebec Pension Plans) or from general tax revenues (for Old Age Security and Guaranteed Income Supplement). In short, they are financed essentially by transfer payments from the working-age population to the retired population. As the proportion of the elderly increases, the burden on the working-age population will also increase.

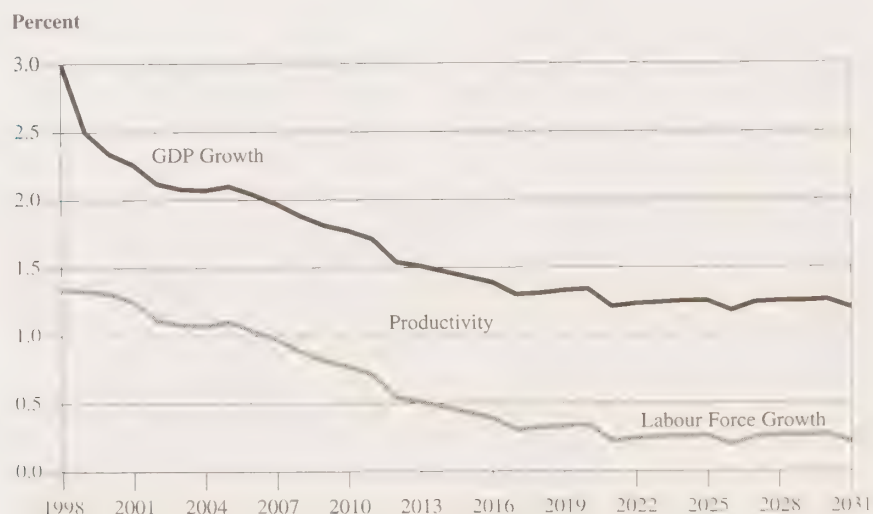
6.47 Exhibit 6.9 displays projections of social security spending to the year

2031, when all baby boomers will have reached retirement age. These projections are based on data provided by the Chief Actuary and assume a one percent annual growth in real wage rates. Projections for the QPP are based on the assumption that future outlays under that program will remain a constant percentage of CPP outlays. Under these assumptions, total CPP/QPP outlays are projected to grow from 2.7 percent of GDP in 1996 to 4.7 percent in 2031.

6.48 The projections for OAS/GIS do not incorporate changes under the proposed Seniors Benefit, since this reform has not yet been legislated and its final form was not known at the time this chapter was completed. Under the existing program, increases in OAS spending lag behind GDP growth in the earlier years of the projection period (since these benefits are linked to prices, not wages), but accelerate past it in the second decade of the next century when the leading edge of the baby boomers reaches OAS eligibility age. By 2031, OAS outlays are projected to rise to 2.9 percent of GDP compared with 2.0 percent today.

6.49 Expenditures under the GIS program also rise over the projection period, but less than OAS benefits and

Exhibit 6.7
Economic Growth Projections



only marginally more than the economy as a whole. This is because GIS benefits are income-tested and thus tend to fall as other income sources grow.

Population aging will intensify pressures on medicare

6.50 Medicare consists of universal, publicly funded access to hospital and physician services. According to Health Canada figures, in 1996 all levels of government in Canada spent an estimated \$52.6 billion on health care, or 6.4 percent of GDP. Cost containment efforts in recent years have resulted in a reduction of health care spending as a share of GDP; that share peaked at 7.5 percent in 1992. In the 1970s, medicare spending averaged less than 5.5 percent of GDP. Most of the growth experienced since then is accounted for by higher spending per user on more and better services and by the relatively higher costs of those services. Even if future increases in per capita spending prove to be lower than in the

past for every age group, medicare expenditures overall will rise as the population ages.

6.51 Health care costs follow a pattern that varies with age. They tend to be relatively high in the earliest years, fall significantly during youth and young adulthood, rise gradually during middle age and then quite steeply during old age (see Exhibit 6.10). Generally, as people age they become more susceptible to illness and health problems that may limit their ability to function independently. The incidence of disabilities, for instance, increases significantly with age. The elderly are also more likely to require physician services, hospitalization or nursing home care. On average, per capita public spending on health for those aged 65 and over is almost five times greater than per capita spending on the rest of the population.

6.52 While health care costs are likely to rise as the population ages, projections

In the 1970s, medicare spending averaged less than 5.5 percent of GDP. Most of the growth experienced since then is accounted for by higher spending per user on more and better services and by the relatively higher costs of those services.

Exhibit 6.8

Canada's Retirement System at a Glance

Canada's retirement income system comprises three basic pillars: a publicly financed system of pension benefits — the Old Age Security (OAS), Guaranteed Income Supplement (GIS) and Spouse's Allowance (SPA) programs; a contributory system of pensions, compulsory for all employed Canadians between the ages of 18 and 65 — the Canada Pension Plan and the parallel Quebec Pension Plan; and a tax-assisted system of private savings — employer-sponsored registered pension plans (RPPs) and individual registered retirement savings plans (RRSPs).

A universal old age pension system was first introduced at the federal level in 1952 (a means-tested pension jointly funded by the federal and provincial governments had been in operation since 1927). Until 1965, OAS benefit eligibility began at age 70. It was then annually lowered by a year to 65 in 1970, where it remains today. The GIS was introduced in 1967; it is payable to all OAS recipients who have limited income from non-OAS sources. A spouse's allowance was introduced in 1975, payable to spouses aged 60 to 64. In 1984, the allowance was extended to widows and widowers aged 60 to 64. Since 1989, OAS benefits have been "clawed back" at a rate of 15 percent of the beneficiary's annual income in excess of a specified threshold that is partially indexed to the CPI.

The CPP/QPP was introduced in 1966. Financed through compulsory contributions by both employers and employees, it provides retirement pensions essentially equal to one quarter of average contributory earnings. Normal retirement age for the CPP/QPP is 65, but contributors may retire as early as 60 at reduced benefits or defer retirement to age 70 and receive higher pensions.

RPPs are employer-sponsored arrangements under which money is set aside during the working life of employees to provide them with income at retirement. RRSPs are individual retirement accounts administered by regulated financial institutions. The *Income Tax Act* encourages the establishment of RPPs and RRSPs by allowing contributions to such plans, up to a specified maximum, to be deducted from taxable income and by exempting the pension plans' income from taxation.

of these costs are difficult to make with any degree of confidence because, in addition to demographics, they depend on many other factors that are highly uncertain. These include trends in the state of health of the elderly and relative inflation in the health care sector. They also include developments in technologies and treatments that, while adding to the quality of service, also tend to increase demand for health services and the need for highly trained — and highly paid — specialists. Finally, changes in the ways

medicare services are organized and delivered can also significantly affect health care costs in the future.

6.53 Exhibit 6.11 shows the results of three separate health cost projections:

- a high-cost projection, which assumes that future age-specific per capita health costs rise at roughly the same rate as that experienced over the past two decades;

Exhibit 6.9

Projected Social Security
Spending as a Percentage of
GDP Projections to 2031

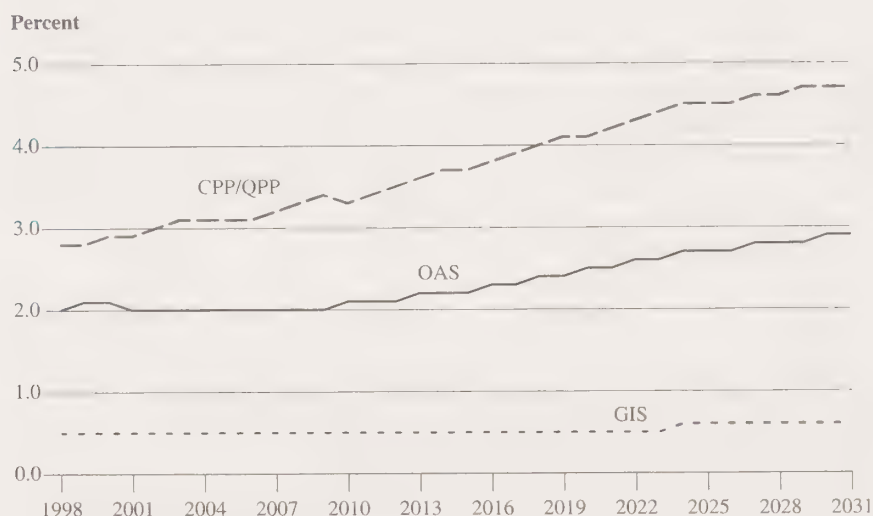
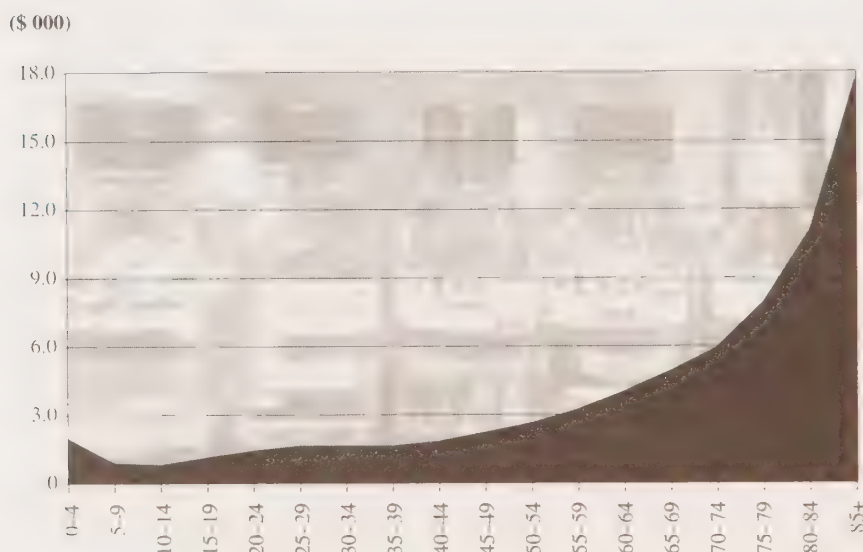


Exhibit 6.10

Health Care Spending per
Capita by Age Group 1993



- a medium-cost projection based on the assumption that per capita health costs rise at the same rate as average wages (which are assumed to increase at an annual rate of 1 percent in real terms); and
- a cost-containment scenario in which health spending per capita rises only with the general price level, that is, age-specific health spending per capita remains constant in real terms.

6.54 We include the third projection — that real per capita health costs remain constant — to isolate the purely demographic effects on health spending. Even with this freeze, overall public health spending would rise significantly in absolute terms, and at about the same rate as projected GDP growth. In both of the other two projections, health care spending rises much faster than GDP over the projection period. In the medium-cost case, health spending rises from 6.4 percent in 1996 to 9.0 percent by 2031. In the “high cost” case, health spending as a share of GDP doubles to 12.5 percent over the same period.

6.55 Exhibit 6.12 summarizes the results of all the foregoing projections. It shows that government spending on social

security and medicare rises from 11.6 percent of GDP in 1996 to somewhere between 14.7 and 20.7 percent by 2031, depending on the assumptions about health care cost increases. In the medium-cost projection (which has per capita health costs increasing at the same rate as the average wage), government spending on social security and health care rises to 17.2 percent of GDP by 2031, 5.6 percentage points higher than today. In today’s economy, such an increase is equivalent to roughly \$50 billion.

Demographic Changes and Government Finances

6.56 Our discussion of the implications of aging indicates that under current policies, increases in government spending on social security and health care could very likely accelerate within a little more than a decade. At the same time, economic growth and government revenue growth are likely to slow down considerably. Together, these forces can result in significant pressures on public finances starting around 2010, when the baby boomers begin reaching retirement age. How well the next generation and its governments are able to cope with these pressures will be determined largely by

How well the next generation and its governments are able to cope with these pressures will be determined largely by annual fiscal decisions made over the coming years.

Percentage of GDP

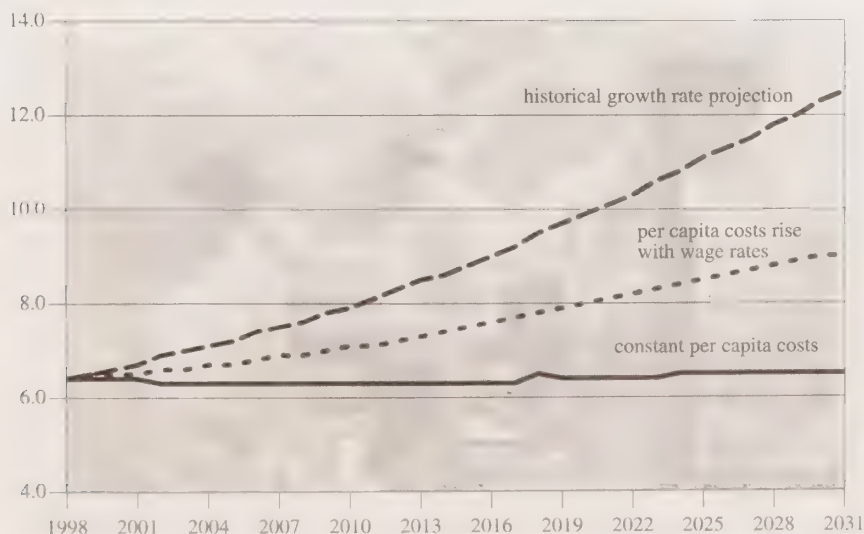


Exhibit 6.11

Projections of Public Health Care
Expenditures as a Percentage of
GDP to 2031

Decision makers are not being provided with sufficient information to understand the potential impacts of demographics, and how these impacts relate to current fiscal decisions.

annual fiscal decisions made over the coming years. The difficulty is that decision makers are not being provided with sufficient information to understand the potential impacts of demographics, and how these impacts relate to current fiscal decisions.

Current budget decisions have long-term fiscal implications

6.57 To provide insight into the kind of information that Canadians need to understand the relationship between annual fiscal balances and intergenerational equity, we projected three fiscal scenarios to the fiscal year 2010, roughly the start of retirement for the baby boom generation. These scenarios can be viewed as different ways of dealing with annual budgetary balances over the next decade or so, before the looming demographic pressures bear down on our public finances. We then discuss the implications of these different scenarios for program spending in the years beyond 2010.

6.58 The assumptions characterizing each scenario are set out in Exhibit 6.13.

In all three scenarios, government revenues are assumed to rise with the growth of the economy, so that the revenue share (as a percentage of GDP) stays constant throughout the projection period. The effective real interest on government debt is set at 5 percent, a rate that is high by historic standards but lower than the average rate over the past two decades. Government outlays on social security rise according to the projections discussed in the previous section. Spending on health care is made to rise with health care spending in general, which in turn is assumed to rise according to the “medium cost” projection set out in the previous section. (Modelling health spending this way may be questioned, since federal spending on health consists primarily of transfers to the provinces, which are not tied to actual spending on health. For a discussion of the rationale for this assumption, see Exhibit 6.14.)

6.59 The three scenarios differ only in the assumptions we make about government “discretionary” spending (program spending in areas other than

Exhibit 6.12

Government Spending on Social Security and Health – Selected Years

	Projections			
	1996	2011	2021	2031
	<i>(as a percent of GDP)</i>			
CPP/QPP	2.7	3.4	4.2	4.7
OAS	2.0	2.1	2.5	2.9
GIS	0.5	0.5	0.5	0.6
Health				
Low ¹	6.4	6.2	6.4	6.5
Medium ²	6.4	7.1	8.1	9.0
High ³	6.4	8.1	10.1	12.5
Total				
Low	11.6	12.2	13.7	14.7
Medium	11.6	13.1	15.4	17.2
High	11.6	14.1	18.4	20.7

¹ age-specific per capita health spending rises with inflation

² age-specific per capita health spending rises at 1% real

³ age-specific per capita health spending rises at 2% real

health and social security), and in the budget balances and debt levels that result from these assumptions.

6.60 Scenario one can be characterized as a case where the entire projected surplus is used for debt reduction. It represents essentially a continuation of the policy of fiscal restraint the government has been following in recent years. In this scenario, discretionary spending to the year 2010 is allowed to rise only with inflation. The fiscal surpluses resulting under this policy, while small at first, grow quickly over time, causing a correspondingly sharp reduction in the government debt. By 2010, the debt-to-GDP ratio shrinks to

23 percent, roughly the same ratio as in the mid-to-late 1970s (see Exhibit 6.15).

6.61 Scenario two can be viewed as a case where all projected surpluses are spent. That is, the budget is kept in balance till the year 2010. This scenario would allow discretionary spending to increase year over year, both in real terms and in relation to the GDP. The stock of debt remains unchanged in this scenario, but the debt-to-GDP ratio falls as the economy grows. Given the economic growth underlying the projections, the debt ratio falls to 42 percent by 2010, which is where it was approximately 14 years ago.

Economic and fiscal assumptions common to all scenarios

Growth in labour productivity	1.00%
Inflation rate	2.00%
Government revenues	rise at the rate of nominal GDP
OAS/GIS growth	indexed to CPI
Per capita health spending	rises with average wages (1% in real terms)
Interest rate on debt	5% real

Fiscal policy assumptions to year 2010

Scenario 1:	"Discretionary" spending* grows with inflation only
Scenario 2:	Balanced budget
Scenario 3:	"Discretionary" spending* grows with nominal GDP

*Program spending other than spending on health care and old age pensions.

Exhibit 6.13

Assumptions Used for Projections

Other than a relatively small portion of direct spending (primarily for service delivery to native Canadians on reserves and to military personnel, and for funding of health protection and promotion activities), federal spending on health consists of contributions to the provinces. These contributions have been effectively decoupled from actual spending on health since 1977, when cost sharing of health expenditures was replaced by a block funding formula under the Established Programs Financing (EPF) Arrangements. EPF tied federal transfers for health and post-secondary education financing to growth in population and the economy, rather than to actual spending on these programs. This basic approach has continued under the Canada Health and Social Transfer, which replaced EPF in April 1996.

Nevertheless, it is probably unrealistic to assume that federal finances will remain unaffected by the increases in health care pressures, particularly since, under the *Canada Health Care Act*, the federal government retains authority for setting standards in the health care field. As spending pressures in the health sector mount, it is likely that either federal contributions will have to be increased or federal tax rates will have to be reduced to provide provinces with room to increase their own rates. This is essentially what has taken place in the past, and it is nothing more than recognition of the fact that in the end, there are two governments taxing one taxpayer.

Exhibit 6.14

Health Expenditure Assumptions

6.62 Scenario three is an intermediate option, where part of the projected surplus is spent and part is used to reduce the debt. More specifically, this scenario assumes that discretionary spending beyond the year 2000 rises at the same rate at which the economy grows. Given the large operating balance at the beginning of the projection period, this scenario also results in substantial and growing budget surpluses over time, though smaller than in the first scenario. The debt-to-GDP ratio in this case falls to about 33 percent by 2010, its level in 1982.

6.63 Clearly, the debt-to-GDP ratio falls significantly from current levels in all three scenarios, but never lower than it was 20 years ago. Moreover, the run-up in debt we have experienced since the mid-1970s occurred despite favourable demographic conditions, with the labour force growing strongly and dependency ratios declining. By contrast, in the years after 2010, labour force growth will be weak and dependency ratios will be rising. In this context, despite the 10 years of

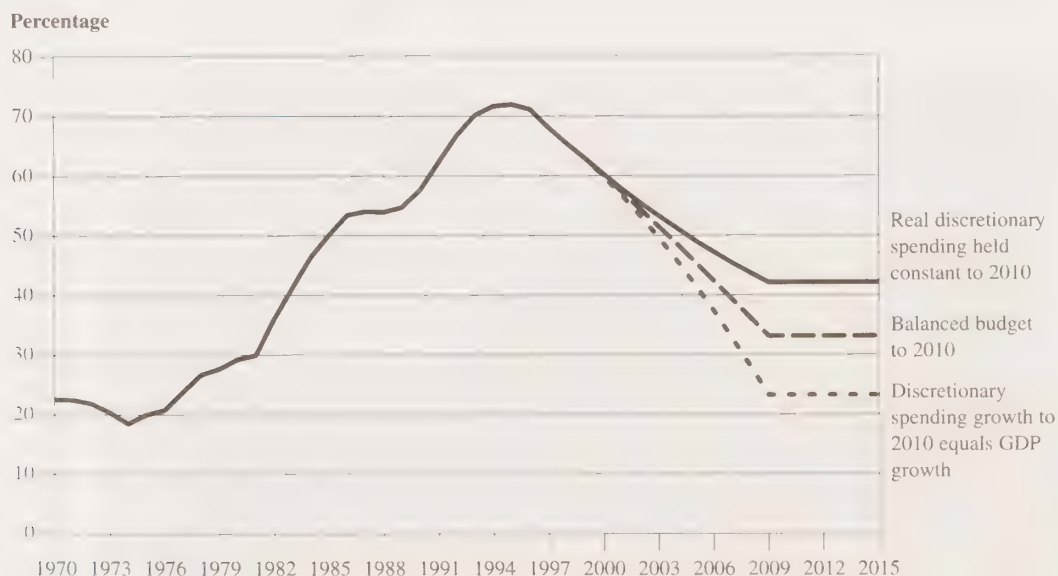
fiscal consolidation represented by each scenario, the government's financial health will still be poorer when baby boomers begin leaving the labour force than when they entered it.

6.64 The projections of discretionary spending in the years beyond 2010 help illustrate this point. Exhibit 6.16 shows average spending on government programs other than social security and health care ("discretionary spending") as a percent of GDP for specific periods to fiscal year 2032. It also shows discretionary spending during 1976–97, for comparison purposes.

6.65 Projections to the year 2010 show the results of the three scenarios described above. Projections beyond 2010 are calculated on the assumption that the debt-to-GDP ratio is held constant at the level where it happens to be in 2010 under each of the three scenarios. The assumptions concerning government revenue growth, interest costs and "entitlement spending" (spending on social security and health) stay the same as before. Discretionary spending is

Exhibit 6.15

Debt-to-GDP Projections to 2015



adjusted to maintain the fiscal balances required to keep the debt ratio constant.

6.66 A number of observations follow from the results displayed in Exhibit 6.16.

6.67 First, under all three scenarios, discretionary spending over the next decade is much lower than in the years thereafter. In part, this represents the price of bringing the debt ratio down, which means that until 2010 the budget is kept in surplus or in balance. It also represents the payoff from this period of fiscal restraint: with a much lower debt burden in the years beyond 2010, a smaller portion of the budget is absorbed by debt service costs and more is left over for program spending.

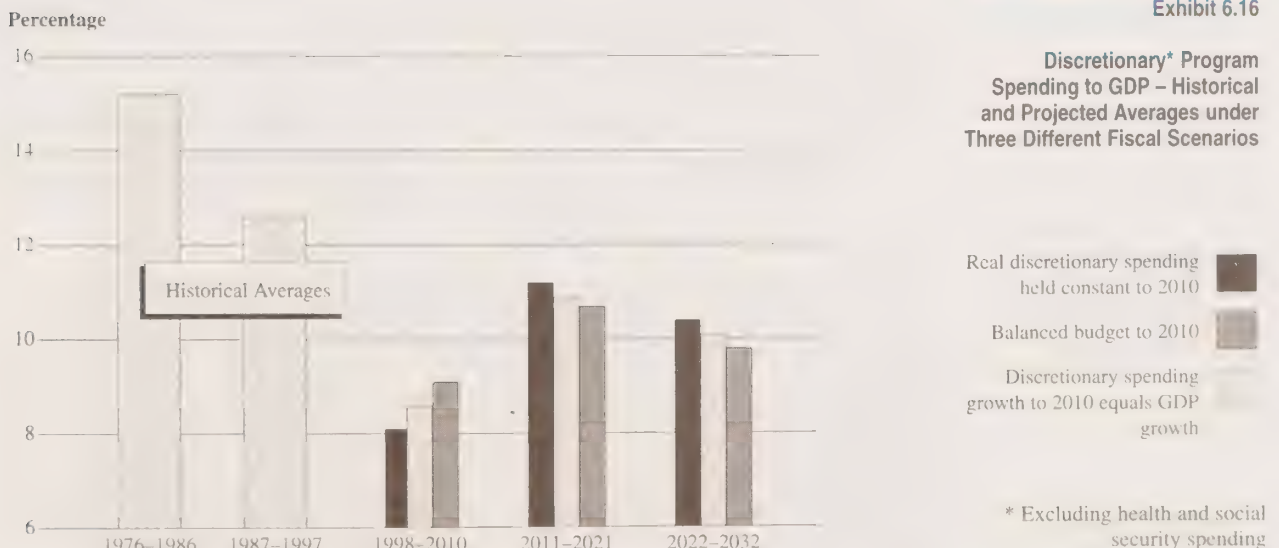
6.68 A measure of the payoff from fiscal restraint is also provided by the differences in the level of discretionary spending associated with each scenario. A policy of “banking” prospective surpluses over the next decade, such as that of scenario one, results in a level of “discretionary” spending in the long term that is approximately 6 percent higher than under the balanced budget scenario. In today’s economy, this amounts to approximately \$5 billion. But even in the

most stringent of the three scenarios, discretionary spending in the second and third decade of the next century remains well below levels experienced in the 1970s and 1980s.

6.69 Each of the three scenarios in effect represents a particular fiscal path to the year 2010. The greater the fiscal restraint associated with a path — that is, the more of the potential surpluses we “bank” rather than spend along the way — the smaller will be the stock of debt at the end of it. A lower debt implies lower debt service payments, and therefore more spending available for programs at any given revenue level. In short, the more we spend today, the less we or our children can spend tomorrow.

6.70 Finally, Exhibit 6.16 also shows that discretionary spending (relative to the size of the economy) is lower in the second half of the period 2011–32 than in the first. This decline reflects primarily the pressures of entitlement spending (OAS/GIS and health) on other programs. As discussed earlier in this chapter, the growth of Canada’s elderly population will accelerate during the second and third decades of the next century, as the huge baby boom generation joins the ranks of

Clearly presented long-term projections, made available to Parliament and the public, can help identify the fiscal challenges that lie ahead and the trade-offs associated with different options for dealing with them.



Population aging is not unique to Canada. Most developed countries and much of the third world will undergo a similar experience in the coming decades.

In recent years, many individual countries have also made a point of reforming their fiscal reporting to reflect more fully the long-term fiscal pressures associated with population aging.

those over 65. Under current policies, this aging trend will result in significant increases in government spending on social security and health care. If these spending increases are to be met without increasing the overall tax burden or the level of indebtedness, government spending in other areas will have to fall.

6.71 In all of the three scenarios discussed here, discretionary spending is the variable that adjusts to meet the different policy-determined fiscal targets. This way of casting policy was done for ease of exposition only. The same targets could also be met through tax changes or through a combination of tax and spending measures.

6.72 Any long-term projections are highly speculative. They are based on assumptions that may turn out to be wrong. But while precise outcomes are uncertain, the overall trend is not: the ratio of working to non-working population will shrink dramatically in the next few decades and this will increase pressures on government spending while reducing the government's capacity to respond. How serious these effects turn out to be will depend crucially on policies followed in the meantime to minimize their impact. Clearly presented long-term projections, made available to Parliament and the public, can help identify the fiscal challenges that lie ahead and the trade-offs associated with different options for dealing with them.

Government Initiatives

Many countries are budgeting within a long-term framework

6.73 Population aging is not unique to Canada. Most developed countries and much of the third world will undergo a similar experience in the coming decades. A number of international agencies, the OECD and World Bank in particular, have been engaged in major research programs to estimate the impact of aging

populations on public finances and to identify ways of dealing with the fiscal challenges involved. In recent years, many individual countries have also made a point of reforming their fiscal reporting to reflect more fully the long-term fiscal pressures associated with population aging.

6.74 The United States and Denmark have probably moved further in this direction than most. Both countries prepare and make public projections of fiscal balances under various assumptions 40 to 50 years ahead. Demographic impacts on public finances are explicitly considered in these projections.

6.75 Other countries, while not engaged in detailed long-term projections, nevertheless supplement their fiscal statements in other ways that introduce a long-term perspective in budget decision making. In New Zealand, for example, the government is required by law to establish long-term fiscal objectives and to discuss in the budget how the government's fiscal plans support those objectives. As part of this process, the New Zealand government has begun reporting on the demographic pressures looming over the following several decades and how these could affect the government's fiscal position. Legislation similar to that of New Zealand is currently before Parliament in Australia.

6.76 Another way of bringing a long-term perspective to budget making is through the production of so-called generational accounts (see Exhibit 6.17.). Generational accounts have been provided in recent years by governments in the U.S., Argentina, New Zealand and Norway. In November 1997, the UK government announced a project to develop such accounts for the UK as well.

Canada is not among them

6.77 Compared with the budget processes just described, the time horizon of Canada's fiscal framework is very short. The fiscal plans presented with the

annual budget extend only two years ahead.

6.78 Regular long-term actuarial analyses of the CPP, the OAS, and several public service pension plans are carried out because legislation requires them. Except for these analyses, however, there is no legal requirement for long-term financial projections of other government commitments, and none is made on a regular basis. A study on the cost of government and expenditure management was completed in 1992 by a joint federal-provincial working group at the request of ministers of finance and treasurers. Part of that study examined future pressures on government spending and provided long-term projections (to the year 2025) of expenditures on health, education and social services, under various economic and demographic assumptions. Also, a number of internal studies have been prepared that look at the long-term economic implications of aging. In the fall of 1997, the government sponsored a conference of experts to discuss such implications.

6.79 More recently, the Department of Finance has developed an economic model that is capable of making long-term projections of potential growth of the Canadian economy. It would not require significantly more resources to supplement that model with a fiscal component that would enable the Department to also prepare long-term projections of budget balances and debt levels.

Conclusion

6.80 Population aging is not a hypothetical problem but a real event that is occurring now. We are living longer and we are having fewer children. These are indisputable facts.

6.81 Also indisputable is the fact that these demographic trends will have a significant impact on the economy down the road. Aging affects the amount and the way we save and therefore the amount we invest in the economy; aging also affects the size and composition of the labour force, which in turn affects the growth in the economy. Of course, events can change, but no event can change the reality that we have a baby boom bulge and that our fertility rates have been below rates that would sustain the existing population level. Unless our productivity somehow increases significantly or patterns of work and retirement change substantially, the current demographic trends suggest that the growth in the economy and the associated growth in government revenues will tail off in the coming decades.

6.82 Demographics can also have an impact on government spending. Under current legislation, the combined costs of Old Age Security and the Guaranteed Income Supplement will rise both in absolute terms and relative to GDP. Health costs in the economy as a whole will also rise relative to GDP. How much this will affect actual federal expenditures depends on a number of factors, including the continuance of the existing fiscal transfers, the likelihood that new federal

The time horizon of Canada's fiscal framework is very short. The fiscal plans presented with the annual budget extend only two years ahead.

The Department of Finance has developed a model to make long-term projections of economic growth. It would not require significantly more resources to modify that model to allow for long-term projections of budget balances and debt levels.

Generational accounts provide a framework for measuring the net impact of fiscal policies on present and future generations. Fiscal policies consist of the taxing and spending decisions of governments. The benefits governments provide their citizens, whether in the form of services or transfer payments, are funded through basically two ways: taxes and borrowing. Generational accounts begin with the basic proposition that money borrowed today will have to be paid for at some time in the future. This means that future taxes must be large enough not only to cover future benefits but also to pay off the net debt accumulated to date. Based on this proposition and on assumptions about demographic and economic trends, generational accounts estimate the net benefits (benefits less taxes) of typical members of different generations.

Exhibit 6.17

Generational Accounts

The lower the debt ratio becomes, the easier it will be for future governments to meet commitments to seniors and to fund other program areas like the environment, science and technology and education.

By having the information publicly available, Parliament and the public can appreciate the long-term fiscal implications of current budgetary choices.

programs like pharmacare and home care will be introduced, and other elements that could affect the federal share of health care expenditures. But if the federal share falls, someone somewhere will have to pick it up, whether it is the provinces or private health care arrangements. Since there is only one taxpayer, if private or provincial financial responsibilities increase there will be pressure to reduce federal taxation.

6.83 The exact magnitude of the impending demographic impact is not certain. However, the direction is clear. We do know that the lower the debt ratio becomes, the easier it will be for future governments to meet commitments to seniors and to fund other program areas like the environment, science and technology, and education. The scenarios we projected point out the nature and extent of the trade-offs involved.

6.84 Of course, events could change that might affect labour force growth or even productivity. Events could also affect the federal government's cost and share of health care. In any case, it is possible to demonstrate that demographics do matter, and that they can affect the long-term financial condition of government.

6.85 The government recognizes this and has done a considerable amount of work on this theme. The Department of Finance has supported academic workshops to encourage debate on the issue and it has built a long-run model to assess the factors involved. To date, however, the government has not made projections of this kind publicly available.

6.86 As an audit office, our role is not to compete with or supplement the work of think tanks and forecasting services that provide a range of predictions for the Canadian economy and government financial health. Our responsibility, among other things, is to comment on the credibility, reliability, and understandability of government financial reporting. As we have said many times

before, that means looking forward, to understand the impact that the future holds in assessing current financial health. In this regard, it is our view that the government has not been sufficiently forthcoming in providing Canadians with information to allow them to make choices that affect not only them today but also generations down the road.

6.87 In this regard, to help legislators and Canadians gain a better appreciation of the fiscal challenges looming ahead, the government ought to produce long-term financial projections on the basis of status quo policies and alternatives. These projections would then be reported to Parliament, either as part of the annual budget presentation or during pre-budget consultations. There are two main reasons for doing this: first, the more transparent information is, the better its quality becomes. There is an expression that "sunlight is the best antiseptic". In this case, even if government projections are not perfect (as is inherent in any projection), public exposure will allow greater scrutiny and ultimately improve the information. The second reason is that if the information is made available publicly, Parliament and the public can better appreciate the long-term fiscal implications of current budgetary choices.

6.88 Finally, in making these suggestions, our purpose is not to put the government in a position of being accountable for financial results five, ten or twenty years down the road. Clearly that would not be fair or feasible. No government could ever publish estimates of its revenues or expenditures for the medium to longer term that it could guarantee it would meet. In this regard, being accountable for two-year rolling targets seems very defensible.

6.89 Yet dealing with the potential fallout that an aging society can have on government's long-term financial condition requires making intelligent choices today. And providing information to help parliamentarians with those

choices is not about being accountable for the longer term, but simply taking the longer term into account. At this juncture, with the aging of the population a virtual certainty, we believe that for government financial reporting to be useful, telling people about the potential impacts that demographics can have is fundamental.

Department's response: *The government continues to conduct its fiscal planning based on a simple strategy — that of achieving long-run goals by setting and meeting realistic short-run targets. This is a measured and responsible approach. It is also an effective approach.*

Moreover, government financial management is not taking place in isolation; rather, government policy is being carried out with full awareness of the fiscal implications of population aging. The government and the Department of Finance have taken concrete steps in both analyzing and addressing the problem of population aging.

Indeed, the very extrapolations contained in the chapter largely replicate the results of a study produced six years ago by a joint working group of Department of Finance and provincial treasury officials. The government is also currently participating in the G-10 Working Party on the Aging of Populations, which is further investigating the economic and

fiscal implications of population aging (population aging is not a phenomenon unique to Canada).

Beyond simply studying the issue, the government has proposed two important policy changes to ensure that our public pension system can be sustained in the face of changing demographics. The first was the 1996 Budget proposal to replace the current Old Age Security and Guaranteed Income Supplement programs with the Seniors Benefit. The fundamental objective of the proposed reform is to slow the growth in costs while protecting and enhancing pensions for low- and modest-income seniors. The second was the recent agreement between the federal and eight provincial governments to reform the Canada Pension Plan. This reform will ensure that the CPP program remains financially sound in the long run and continues to be in place for future generations.

The government believes that presenting long-run fiscal projections to Parliament every year would serve only to detract attention from the important goal of debt reduction. The best approach to fiscal management is the considered and deliberate one of achieving long-run goals through realistic short-run targets, and taking tangible measures to ensure that programs remain sustainable in the face of upcoming demographic changes.

Providing long-term financial information is not about being accountable for the longer term, but simply taking the longer term into account publicly.



About the Study

Objectives

The objectives of this study were twofold:

- to demonstrate the significance of a long-term perspective to a proper appreciation of the government's current financial condition, with specific reference to the fiscal implications of current demographic trends; and
- to draw attention to the inadequacy of the information provided by the government to Parliament and the public about the implications of current demographic trends and their potential impact on current fiscal decisions.

Scope and Approach

The study focussed on projected demographic developments over the next three to four decades and the implications of these developments for government revenues and expenditures. It also examined the federal budgetary process, with special emphasis on fiscal projections by the Department of Finance and the public reporting of those projections.

The findings of the study were based on:

- a review of published information on demographic trends and their long-term fiscal implications;
- Statistics Canada census and economic data and population projections;
- actuarial projections by the Chief Actuary of the OAS/GIS and CPP programs;
- examination of internal studies and working papers on demographics and economic growth by the Department of Finance, and interviews with departmental officials;
- a review of budgetary reporting practices in Canada and several other developed countries.

The choice of the projection period, to the year 2031, was dictated by our interest to capture the impact of the retirement bulge represented by the aging of the baby boom generation and still remain within a reasonable time frame.

Study Team

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Report of the Auditor General of Canada to the House of Commons – 1998

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Report of the
Auditor General
of Canada
to the House of Commons

Chapter 7
Federal Laboratories for Human and
Animal Health Building Project

April 1998

**Report of the
Auditor General
of Canada
to the House of Commons**

Chapter 7
Federal Laboratories for Human and
Animal Health Building Project



April 1998

This April 1998 Report comprises 9 chapters and a Foreword and Main Points. In order to better meet clients' needs, the Report is available in a variety of formats. If you wish to obtain another format or other material, the Table of Contents and the order form are found at the end of this chapter.

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Cat. No. FA1-1998/1-7E
ISBN 0-662-26795-8

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Chapter 7

Federal Laboratories for
Human and Animal Health
Building Project

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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Federal Laboratories for Human and Animal Health Building Project

Main Points

7.1 The new Federal Laboratories for Human and Animal Health in Winnipeg contain some of the most advanced diagnostic, research and training facilities of their kind in the world. The facility is the first in the world to combine laboratories concerned with both human and animal diseases, and the first in Canada capable of handling the most dangerous viruses known. The facility is to be used by Health Canada and the Canadian Food Inspection Agency.

7.2 International experts involved in reviewing the design and construction of the facility have noted that it is extremely secure with regard to containment of biohazardous materials.

7.3 Despite a lengthy history of project proposals by Agriculture and Agri-Food Canada and Health Canada to construct new laboratory facilities, the Winnipeg project was undertaken without adequate analyses of existing laboratory capacity. The Winnipeg facility currently has space that exceeds its planned program needs and the amount approved by Treasury Board, and that has added to a national inventory of surplus laboratory capacity.

7.4 Health Canada and the Canadian Food Inspection Agency have informed us that they recognize the importance of ensuring that the facility is fully used, including the need to explore potential cost-recovery opportunities. To date, however, a comprehensive business plan and strategy for achieving these aims has not been developed.

7.5 In our opinion, the project is approximately 12 months behind schedule and could have been delivered for at least \$5 million to \$10 million less. In addition, the approved project budget of \$141.8 million does not accurately reflect the project's total cost to the taxpayer, currently estimated at \$176 million. The proposed project budget did not identify all project costs, as required by Treasury Board policy.

7.6 We identified several areas where Public Works and Government Services Canada can improve its practices in selecting and managing consultants on future complex projects like this one. We also noted that shared authority and accountability require careful management to mitigate risks of project delays and added costs.

7.7 As we have noted in reviewing other government projects, the current "build [up] to budget" approach, the lack of systemic incentives for seeking cost savings within approved budgets, and the absence of a departmental culture that supports such aims do not encourage the parties to identify and realize potential cost savings.

7.8 The new facility is a potential source of pride for all Canadians as it contributes to the global effort to identify and combat human and animal infectious diseases. Due to the nature of its programs, the Winnipeg laboratories will be expensive to operate and maintain. The challenge for Health Canada and the Canadian Food Inspection Agency will be to ensure that the full potential of this new facility is achieved.

Introduction

7.9 Health Canada and Agriculture and Agri-Food Canada (Agriculture), the two client departments, are jointly constructing world-class laboratories in downtown Winnipeg. Public Works and Government Services Canada (Public Works) is the contracting authority and is responsible for delivering the project. Effective 1 April 1997, Agriculture's portion of the Winnipeg facility was transferred to the Canadian Food Inspection Agency (CFIA), but Agriculture continues to provide project management services to CFIA.

7.10 The new building contains some of the most advanced diagnostic, research and training facilities of their kind in use, and has been described by international experts as a benchmark example for the world. The facility is the first in the world to combine laboratories concerned with

both human and animal diseases, and the first in Canada to include laboratories at "biosafety level 4", capable of handling the most dangerous viruses known. Exhibit 7.1 describes the four levels of biosafety and laboratory containment.

Program roles for the Winnipeg laboratories

7.11 Health Program. The mission of Health Canada's Health Program is to help Canadians maintain and improve their health. The Laboratory Centre for Disease Control (LCDC) is part of the Department's Health Protection Branch, and, through well-established Canadian public health networks, carries out disease surveillance, risk assessment and control of diseases of national and international importance and concern.

7.12 The Bureau of Microbiology is the primary component of LCDC that is scheduled to move to the new Winnipeg

The facility is the first in the world to combine laboratories concerned with both human and animal diseases, and the first in Canada to include laboratories at "biosafety level 4".

Exhibit 7.1

Biosafety and Laboratory Containment Levels

Biosafety level 1

- This level applies to the basic laboratory for the handling of biological agents that are unlikely to cause disease in healthy workers or animals. Biosafety level 1 requires no special design features beyond those suitable for a well-designed and functional laboratory.

Biosafety level 2

- This level is suitable for work with agents that can cause human or animal disease but that, under normal circumstances, are unlikely to be a serious hazard to laboratory workers, the community, livestock, or the environment.

Biosafety level 3

- This level is suitable for work with agents that can cause serious human or animal disease or result in serious economic consequences, but that ordinarily are not spread by casual contact from one individual to another or that can be treated by antimicrobial or antiparasitic agents. The physical and operational requirements of a level 3 laboratory are substantially greater than those for levels 1 and 2.

Biosafety level 4

- This level is for work with agents that can produce very serious human or animal disease that is often untreatable, and that may be readily transmitted from one individual to another or from animal to human or vice versa, directly or indirectly or by casual contact. The physical and operational requirements are highly specialized.
- Biosafety level 4 is the highest level of containment and represents an isolated unit functionally independent of other areas.
- This level of containment requires, for example, an air lock for entry and exit, biological safety cabinets or positive-pressure ventilated suits, a laboratory support area, and a separate ventilation system.

Source: Health Canada
Laboratory Biosafety
Guidelines, 1996

laboratories. The Bureau focusses on a wide range of bacterial, viral and rickettsial pathogens, including hantaviruses, hepatitis, influenza viruses and others. In addition to its new Winnipeg laboratories, the Bureau operates six national centres across the country in collaboration with provincial laboratories, each dealing with a specialized area of microbiology.

7.13 The Winnipeg laboratories are intended to facilitate the Bureau's ongoing work and enhance its ability to manage emerging disease issues, through a network of national and international public health organizations as well as universities and industry partners.

7.14 The Canadian Food Inspection Agency. CFIA delivers inspection and related services that contribute to a safe and wholesome food supply in Canada. Its work also facilitates trade in food and in animal, plant and food products, both interprovincially and internationally.

7.15 The Canadian Food Inspection Agency's National Centre for Foreign Animal Disease (NCFAD) will be located at the Winnipeg laboratories. It focusses on diagnostic testing to identify devastating foreign diseases that could threaten Canadian livestock. NCFAD laboratory personnel are responsible for making initial diagnoses and for training

field veterinarians in the early recognition of exotic diseases. NCFAD is also tasked with responding to any foreign disease outbreaks, and it provides analysis and advice for the development of policy on any one of 30 or more exotic diseases that may threaten human and animal health. A 1985 study conducted by Agriculture Canada calculated that an outbreak of foot-and-mouth disease in Canada resulting in an embargo period of 1.5 years would cost the producers an estimated \$2.8 billion in losses.

7.16 In summary, the key program roles of both Health Canada and the Canadian Food Inspection Agency that are to be carried out in the new Winnipeg laboratories include:

- diagnosing human and animal diseases;
- developing new diagnostic methods;
- responding to acute outbreaks of diseases across Canada;
- training federal and provincial scientists and health officials; and
- evaluating methods for controlling and eradicating diseases.

The Winnipeg project

7.17 The new Winnipeg facility comprises approximately 28,300 square

Federal Laboratories for Human and Animal Health in Winnipeg—new world-class facilities for Canada (see paragraph 7.10).



metres, including laboratories with biosafety containment levels ranging from 2 to 4. The majority of Health Canada's laboratories require level 2 containment design standards, typical of many laboratories associated with universities, pharmaceutical companies and hospitals. The majority of CFIA's laboratory space is level 3. Exhibit 7.2 provides details of the facility's space allocations.

7.18 In addition to the laboratory and office space, the facility includes a 137-person-capacity auditorium for training purposes, common areas such as the cafeteria, the library, service and storage areas, and support infrastructure.

7.19 Approximately 180 staff members are expected to work in the facility when it becomes fully operational in late 1998. A further 45 Public Works staff will operate and maintain the building. At the completion of our field work, 70 positions had not yet been staffed. Senior program officials believe that staffing these positions with the right people is a challenge that must be met to ensure program delivery.

7.20 Project management framework. The departments entered into a Memorandum of Understanding in March 1990 (subsequently revised July 1994 and January 1997), which established an independent project management framework. The framework

reflects a two-tier committee structure comprising a Project Steering Committee and several operational committees.

7.21 The Project Steering Committee is responsible for the overall direction and conduct of the project. It currently comprises five assistant deputy ministers – two from Health Canada, and one each from Agriculture, the Canadian Food Inspection Agency and Public Works. The Chair alternates between the two client departments. Day-to-day management of the project is carried out through the Client Management Committee and the Project Management Committee. The Client Management Committee comprises senior officials from the program areas of the two client departments and their facilities management officials. The Project Management Committee consists mainly of the project managers and other project staff of the two client departments and is chaired by the Public Works project manager.

7.22 Project budget and schedule. The approved project budget for the Winnipeg facility is \$141.8 million, funded about equally by Health Canada and Agriculture. Annual operating and maintenance costs are estimated at \$9.0 million, funded on a 70 percent/30 percent split between Health Canada and Agriculture. The identified project schedule when Treasury Board granted effective project approval in August 1992

Space Use	Health Canada	Canadian Food Inspection Agency	Common	Total
Administrative/Office	1,117	410	476	2,003
Circulation	1,605	441	1,572	3,618
Mechanical/Electrical	3,466	1,875	3,797	9,138
Other	476	23	4,682	5,181
Biosafety Level 2	4,596	717	0	5,313
Biosafety Level 3	666	2,110	30	2,806
Biosafety Level 4	181	78	0	259
Total	12,107	5,654	10,557	28,318

Exhibit 7.2

Winnipeg Laboratory Space Allocations

(gross space in square metres)

Source: Project team, based on design calculations only, accuracy ± 10 percent

We examined the major aspects of the design and construction of this major Crown project from the perspective of the generally accepted phases of good project planning and implementation.

is shown in Exhibit 7.3. Actual and projected dates are also shown. Exhibit 7.4 presents a chronology of key events leading to the approval of the Winnipeg facility project.

Focus of our audit

7.23 We examined the major aspects of the design and construction of this major Crown project from the perspective of the generally accepted phases of good project planning and implementation. Because of the nature of the work that will be carried out in the facility, we were particularly interested in assessing whether appropriate measures were taken to ensure employee and community safety. Our interest in Health Canada, Agriculture and Canadian Food Inspection Agency program issues was limited to obtaining a general understanding of the program requirements that the new laboratories were designed to meet.

7.24 Health Canada has also recently constructed new laboratory facilities at its Tunney’s Pasture campus in Ottawa. The Winnipeg and Ottawa projects were initially planned and managed as one, but

were subsequently separated and treated as two distinct projects. Our audit focussed on the Winnipeg project. Further details on audit objectives, criteria, scope and approach can be found at the end of the chapter in the section **About the Audit**.

Observations and Recommendations

7.25 While we consider all aspects of delivering a major Crown project to be important, we believe that meeting the functional and safety requirements for the Winnipeg laboratories is the most critical aspect of this project for the general public, the scientists and staff employed in the new facility and residents of the surrounding community in Winnipeg.

Biosafety

Appropriate measures taken to ensure employee and community safety

7.26 Biosafety is an abbreviation of “biological safety” and is concerned with the maintenance, safe handling and

Exhibit 7.3
Project Milestones

Activity	Planned	Actual or Projected
Project Brief	November 1990	June 1991
Design	January 1993	May 1993
Construction Complete	March 1996	Interim Certificate of Completion issued 24 October 1997. Final Certificate of Completion expected to be issued by June 1998.
Commissioning/ Testing	June 1997	Commissioning is being carried out in phases and is expected to be completed by April 1998.
Move-in	June 1997	The Canadian Food Inspection Agency began to move in October 1997 and expects to be fully operational in the spring of 1998. Health Canada is planning to move in during spring/summer 1998. Level 4 laboratories could be ready for operations by fall 1998.

Source: Joint Health and Welfare Canada — Agriculture Canada Treasury Board Submission, August 1992

containment of micro-organisms that are infectious to either humans or animals or both.

7.27 We are satisfied that issues affecting employee and community safety have been of primary concern throughout the project. An extensive commissioning process has been used to ensure that all biosafety requirements are met.

International experts involved in reviewing the design and construction of the facility have noted that it is extremely secure with regard to containment of biohazardous materials. In January 1996, the appropriate program and project officials prepared a document that demonstrated that the facility met, and in some cases exceeded, the laboratory biosafety guidelines issued by Health Canada and the Medical Research Council of Canada. Officials are planning to update that study, and they advise us that biosafety experts will sign off the results of all relevant commissioning tests to ensure that the constructed facility meets the appropriate standards.

7.28 Since the inception of the project, the project team has been committed to ensuring that the public has had the opportunity to comment at each major step of the project's development. A September 1997 public consultation report, commissioned by the project team, concluded that the public consultation process has resulted in a positive relationship with the community, which generally continues to be supportive of the facility.

Roles and reporting relationships need to be strengthened

7.29 Health Canada's Office of Biosafety was formed in 1980 to collect, review, store, and disseminate up-to-date information on the safe design, construction and operation of laboratories in Canada. The Office's main functions are to provide consultative services on request to microbiology laboratories in

hospitals, universities, public health laboratories and research facilities. This includes assistance with problems in safety operations as well as total-facility evaluations. The Office was instrumental in developing and updating the laboratory biosafety guidelines. The Director of the Office of Biosafety now reports to the Director of the Bureau of Microbiology and, we are advised, will soon report to the Director General, LCDC.

7.30 In 1992, the Treasury Board Guide on Occupational Safety and Health was revised to encourage all microbiological laboratories of the federal government to conform to Health Canada's Laboratory Biosafety Guidelines. We note, however, that the Treasury Board guidelines do not contain any provision for monitoring compliance with the guidelines. The decision to involve the Office of Biosafety during the design, construction or operation of a laboratory facility is at the discretion of departmental managers.

7.31 The Biohazard Containment and Safety Unit of Agriculture and Agri-Food Canada was originally formed in 1993 to provide containment and biosafety services to the Animal and Plant Health Directorate. In 1997, this unit joined the Science Advisory and Management Division of the Canadian Food Inspection Agency. The Director of the Division reports to the Director General, Animal and Plant Health, who in turn reports to CFIA's Vice-President of Programs.

7.32 The Unit provides direction to CFIA staff on containment of animal pathogens and biosafety practices. It establishes standards for containment facilities handling animal pathogens and determines the appropriate containment level for each animal pathogen under CFIA control. Under an internal certification program, the Unit ensures that the CFIA facilities meet the physical requirements and operational practices outlined in the Containment Standards for Veterinary Facilities. The Unit also

International experts involved in reviewing the design and construction of the facility have noted that it is extremely secure with regard to containment of biohazardous materials.

Exhibit 7.4

**Chronology of Key Events
Leading to the Winnipeg
Project**

27 May 1975	Treasury Board (TB) approved in principle the construction of a new Animal Virus Laboratory (AVL) as part of Agriculture's long-range construction program.
7 February 1980	TB approved in principle the construction of the AVL in Ottawa, at a cost not to exceed \$36.4 million. The project was to be completed by 1984-85.
March 1982	TB approved Health Canada's request to develop a construction/renovation program to improve occupational health and safety in the Health Protection Branch.
20 September 1982	TB authorized Public Works to engage design consultants to produce a class "B" control budget for the AVL project. Construction costs estimated at \$52.7 million.
January 1984	Consultant report on Health Canada's virus laboratory recommended constructing new facilities to house the Bureaus of Microbiology and Biologics, at an estimated cost of \$52.4 million. Construction and occupancy to be completed by July 1990.
5 December 1985	TB gave preliminary project approval for the construction of a new Health Canada virus research building in Ottawa, at an estimated cost of \$93.2 million.
October 1986	Revised cost estimates for the AVL project increased to \$92.9 million. Agriculture asked TB to withhold construction approval for three years until it was able to review its program and laboratory design requirements.
December 1986	As part of the government's restraint program, TB withdrew funding of \$52.3 million for the AVL project to be built on the Woodroffe Campus.
30 January 1987	Public Works issued a proposal call for consulting services for the LCDC and the Bureau of Biologics project to be built in the National Capital Region. Construction costs estimated at \$80 million and project scheduled to be completed and commissioned by September 1993.
22 June 1987	Meeting between Agriculture and Health Canada to discuss the feasibility of undertaking a joint project in Winnipeg.
30 June 1987	Minister of Public Works approved the prime consultant to design the LCDC and Bureau of Biologics Ottawa project.
September 1987	Minister of Health announced that the \$93.2 million LCDC project was being transferred to Winnipeg.
17 December 1987	TB approved \$93.2 million for the new Health Canada LCDC building in Ottawa and the microbiology laboratory in Winnipeg. Health Canada was asked to review the cost estimates for these two laboratories, seek TB approval for the change in scope of the LCDC project, and seek preliminary project approval for the microbiology laboratory. TB stressed that the total costs for the two buildings should not exceed \$93.2 million.
3 May 1988	Health Canada and Agriculture requested Public Works to develop jointly two laboratory facilities, one in Winnipeg and one in Ottawa, on an accelerated basis at an estimated total cost of \$120 million to \$130 million.

Source: Health Canada and
Agriculture and Agri-Food
Canada

supports the Animal Health Division's import program by certifying all facilities in Canada wishing to import or transfer an animal pathogen.

7.33 We noted that the roles and responsibilities of the Biosafety Branch of the U.S. Centers for Disease Control and Prevention (CDC) are more formalized and that the Biosafety Branch enjoys greater independence than its Canadian counterpart, reporting to the Deputy Director of CDC. The Branch is involved at all stages of design, construction, renovation, maintenance and repair of CDC laboratories at biosafety levels 2, 3, and 4, and it formally certifies laboratories before they begin to operate. On a request basis, the Branch is also consulted concerning the safe design and operation of similar laboratories in the public and non-profit domains within and outside the U.S. A recent U.S. federal regulation requires government, university and industry laboratories working with certain infectious agents to register with CDC. We were advised that registered laboratories are periodically inspected by CDC and that the responsibility for managing the regulation rests with the Biosafety Branch.

7.34 We believe that the roles and responsibilities of the Office of Biosafety and the Biohazard Containment and Safety Unit need to be strengthened. In our view, there is a need for these specialists to systematically review all laboratories dealing with infectious agents and to formally attest that the relevant biosafety guidelines are being followed. We believe this is particularly appropriate at a time when Canada is embarking on working with the most dangerous viruses known, and has the potential for future program expansions. We also believe that the reporting relationship of the biosafety offices needs to be independent of program managers in order to minimize any real or perceived conflict of interest.

7.35 Health Canada and the Canadian Food Inspection Agency should review the roles and reporting relationships of the Office of Biosafety and the Biohazard Containment and Safety Unit respectively with a view to strengthening them and to minimizing any real or perceived conflict of interest.

Health Canada and Canadian Food Inspection Agency response: Agreed. Health Canada and the Canadian Food Inspection Agency will be reviewing the role and reporting relationship of the Office of Biosafety and the Biohazard Containment and Safety Unit, respectively, to examine the most effective way to deliver their services. Health Canada, subject to the will of Parliament and in the context of the Health Protection legislative renewal exercise, will examine the issue of the manipulation of human pathogens to determine whether additional legislative controls should be in place at the federal level.

Needs Definition and Options Analysis

Decision to construct new facilities was taken without analyzing existing capacity

7.36 Documentation of the need for new laboratory facilities for Agriculture and Agri-Food Canada dates back to 1975 (see Exhibit 7.4) and earlier, and for Health Canada to 1982. Various plans and projects to replace and augment existing facilities were established and then deferred or abandoned, sometimes at a significant cost to the taxpayer. The most recent example was the October 1986 cancellation of a new Animal Virus Laboratory slated to be built in Nepean, Ontario. That project was cancelled because the estimated cost had increased from around \$52 million to about \$93 million. By the time the project was cancelled, however, approximately

We believe that the roles and responsibilities of the Office of Biosafety and the Biohazard Containment and Safety Unit need to be strengthened.

\$5.5 million had already been spent on plans and specifications.

7.37 The Winnipeg project was formally initiated in September 1987. The justification presented to the Treasury Board by the two client departments for new facilities, including the requirement for high-containment level 4 facilities, was based on the following rationale:

- existing facilities were inadequate;
- programs undertaken were limited because existing facilities could not provide the necessary containment control;
- an outbreak of a major exotic animal disease could have major economic ramifications in terms of lost trade;
- there had been an increase in and re-emergence of global infectious diseases; and
- the possibility of contracting out the departmental requirements would not be a viable option.

7.38 Our audit confirmed that both departments needed to upgrade and augment existing facilities in order to carry out their mandated programs efficiently and effectively. Part of the new facilities in Winnipeg addressed a capacity and program need that could not be met in any laboratories in Canada. However, at the time the decision was made to construct the new facilities in Winnipeg, an in-depth analysis of each department's overall laboratory profile and capacity to meet current and future needs had not been conducted. It was not until April 1996 that Health Canada commissioned a study to assess the Department's current and future needs for laboratory services and facilities. The new federal laboratories in Winnipeg are considered a keystone of Health Canada's microbiological laboratory services and capacity and were not included in the study analysis.

7.39 The Health Canada study concluded, in part, that the Department was spending significant amounts of maintenance dollars on what appeared to excess laboratory capacity, and recommended that a laboratory space optimization study be carried out. Health Canada officials acknowledge that there was a tendency in the past to intentionally overbuild capacity in anticipation of future growth to manage unexpected contingencies, which often did not materialize.

7.40 Health Canada has another laboratory facility in Winnipeg. The two-storey building, completed in October 1987 at a cost of approximately \$12 million, comprises a total gross area of over 5,900 square metres. We observed that the facility was being underused, and were advised by Health Canada that the excess space is due to planned overcapacity for future growth that did not materialize because of government downsizing and consolidation of programs. We also noted that the facility includes a containment laboratory that has never been commissioned or operated, or evaluated for its potential to meet part of the program needs being transferred to Winnipeg.

7.41 In July 1997, the Canadian Food Inspection Agency established a task force to assess the future level of laboratory and quarantine support service it requires. The objective is to develop options for reducing the cost of laboratories and quarantine inspection with minimal impact on service. CFIA informed us that the study had not been completed by the end of our field work, and that the scope had been enlarged to include a broader consideration of options. It is not yet clear when the study will be completed.

7.42 Health Canada and the Canadian Food Inspection Agency should include the capacity of the Winnipeg laboratories in their ongoing

At the time the decision was made to construct the new facilities in Winnipeg, an in-depth analysis of each department's overall laboratory profile and capacity to meet current and future needs had not been conducted.

assessments of their national laboratory requirements.

Health Canada and Canadian Food Inspection Agency response: Agreed.

Constructed space exceeds approval and requirement, with no strategy to optimize use

7.43 In our opinion, the new Winnipeg facility can accommodate significantly more than the number of scientists and support staff planned for occupancy. We noted several facts that would indicate that the constructed net space has increased and that surplus capacity now exists.

7.44 In seeking additional project funding in May 1991, the client departments assured Treasury Board that they had reviewed their programs and eliminated all unnecessary redundancies. The total space requirements at that time were stated as 10,900 net square metres. When seeking effective project approval in August 1992, the total space requirement had grown to 12,200 net square metres, without a corresponding increase in program requirements. The constructed net space, as listed by the prime consultant in May 1996 in a marketing brochure, totalled 13,000 net square metres, representing increases of approximately 20 percent over the initial requirement and 7 percent over the revised requirement.

7.45 The project brief, dated June 1991, states that the total net area of 3,600 square metres of existing Agriculture laboratories and cubicles in Hull, Quebec would be accommodated in 2,568 square metres net space assigned to the Department in the Winnipeg facility. However, the brief notes that Health Canada's Bureau of Microbiology, currently occupying 2,500 square metres in four buildings at Tunney's Pasture in Ottawa, will be replaced by 5,610 square metres of net area in the Winnipeg facility,

more than double the space. A consultant's review of the brief, commissioned by Health Canada, noted that the Winnipeg facility would provide Health Canada staff with about double the amount of space provided to their American counterparts at CDC.

7.46 In a letter to Health Canada dated October 1996, an expert from the World Health Organization serving on the Winnipeg project's Blue Ribbon Review Committee noted that the facility could probably hold two to three times the number of scientists and support staff now planned for occupancy. Furthermore, a senior CFIA program manager noted that under certain scenarios its portion of the facility could accommodate more people than currently planned for occupancy.

7.47 On a national basis and excluding the Winnipeg facility, Health Canada's total functional laboratory space utilization ranges from 27 to 86 square metres per professional scientific staff member, with a program average of 54 square metres. The Winnipeg facility has about 100 square metres per professional scientific staff member, or about double the size. It also has more than double the amount of space per staff member in the recently constructed wing of the LCDC facility in Ottawa.

7.48 Both departments have informed us that they recognize the importance of ensuring the full use of the Winnipeg facility's capacity, including the need to explore potential cost-recovery opportunities. At the end of our field work, however, a comprehensive business plan and strategy for achieving these aims had not yet been developed.

7.49 **Health Canada and the Canadian Food Inspection Agency should conduct a space utilization study of the new Winnipeg facility to determine how much surplus space is available. A comprehensive business plan and strategy should be developed for the facility to ensure that its**

In our opinion, the new Winnipeg facility can accommodate significantly more than the number of scientists and support staff planned for occupancy.

capacity is fully utilized and to explore potential cost-recovery opportunities.

Health Canada and Canadian Food Inspection Agency response: Agreed.

Inadequate analysis and implementation of options results in unproductive payment and higher costs

7.50 We noted several options for cost savings that were not implemented in a timely manner or were not adequately explored by the project team. For example, when it became apparent in 1991 that the cost of the combined Ottawa and Winnipeg projects would significantly exceed the approved budget, the project team decided to retrofit and expand an existing facility in Ottawa rather than constructing a new stand-alone facility as then proposed. It was estimated that this retrofit option would save approximately \$10 million without affecting program delivery. In our opinion, the viable retrofit option should have been considered earlier in the planning process, even in the absence of a budget limitation. If this had been done, the project would have benefited from the estimated \$10 million saving at the outset, and would also have avoided approximately \$2 million paid in fees and expenses for abandoned work on the stand-alone option.

7.51 In 1993, one member of the project team became concerned that the project risked going over budget by approximately \$15 million. He identified, and reported to a senior departmental official, several cost-saving options that he believed would not impact program delivery. The proposed cost-saving measures consisted of reducing the amount of Health Canada laboratory space, modifying some architectural features and eliminating the auditorium. The rest of the project team, however, did not share the view that the project was over budget and did not support the proposed cost-saving measures. In our view, these potential cost savings were of

a nature and significance to warrant a formal review and consideration by the Project Steering Committee.

Financial Management and Control

7.52 Realistic budgets, sound cost control measures and accurate and timely reporting underpin a good financial management and control framework. For the system to work properly, budget estimates need to be reviewed rigorously and challenged by senior managers and Treasury Board officials when approving projects, to ensure that the project is sufficiently funded and to safeguard against approving funds in excess of need. The approved budget provides a yardstick against which the project's financial progress can be measured. Accurate and timely reporting of actual compared with budgeted costs allows decision makers to address any significant variance or exception. In our opinion, stronger financial management and control were needed on the Winnipeg project.

Preliminary project budget was incomplete and subsequent increases not well supported

7.53 In January 1989, Health Canada and Agriculture prepared a joint submission to Treasury Board requesting preliminary project approval to develop a project for \$145 million, of which \$93.9 million related to the joint Health Canada and Agriculture project in Winnipeg and \$51.1 million to Health Canada's Disease Control Centre in Ottawa. The departments advised Treasury Board that the \$145 million budget included resources to completely fit up both centres to provide turn-key operations. We noted, however, that Public Works believed a more realistic budget of approximately \$173 million was required to deliver the project and, accordingly, did not endorse the Treasury Board submission. Public Works officials informed Treasury Board Secretariat

In our opinion, stronger financial management and control were needed on the Winnipeg project.

officials of the higher cost estimate, but this information was not reported in the Treasury Board submission.

7.54 In June 1989, Treasury Board granted preliminary project approval on the condition that preparation of final design documents was not to proceed until it could be assured that projected costs would not exceed \$145 million. In May 1991, after it became apparent that the project could not be delivered within the approved budget, a revised budget of \$183.5 million was requested, of which \$141.8 million would be for the Winnipeg facility. The departments explained that the increased costs were due to inflation, GST, contingencies, site development costs and project management and consultant costs, and attributed 50 percent of the cost increase directly to inflation and the GST.

7.55 We did an analysis of the impact on the project budget of inflation and the introduction of the GST. According to Statistics Canada data, there was actually a slight decrease in inflation (in the non-residential building construction price indexes) between 1989 and 1991. With respect to the GST, we calculated the impact (net of the Manufacturing Sales Tax) to be less than 10 percent of the cost increase. Therefore, we conclude that the combined impact of these two factors accounted for less than 10 percent of the increase and that Treasury Board was not

provided with an accurate explanation for the project cost increases.

Approved project budget does not accurately reflect total project costs

7.56 In August 1992, Treasury Board approved the \$141.8 million budget requested for the Winnipeg facility. We found that the precise nature and extent of activities intended to be financed by the budget were not made clear.

7.57 We were informed that the two departments adopted different philosophies in preparing their respective budgets. For example, the project budget included a total of about \$10.5 million for staff relocation costs, client disbursements and equipment. Agriculture's budget included \$5.8 million for equipment purchases, whereas Health Canada identified only \$650,000 within the project budget and is now funding about \$9.3 million internally for its equipment. Health Canada is also funding an additional \$9.6 million from non-budget resources to relocate affected personnel, whereas Agriculture is funding these costs from its share of the \$141.8 million project budget. We also found that the departments spent an additional \$9 million from non-project funds to administer the project. Exhibit 7.5 provides a more realistic total cost to construct and operate the facility.

7.58 In our opinion, at the effective project approval stage, Treasury Board

We found that the precise nature and extent of activities intended to be financed by the budget were not made clear.

One-Time Costs	(\$ millions)	Ongoing Costs	(\$ millions)
Construction	101.4 *	Operations and Maintenance	9.0
Equipment	25.2	Incremental Resources for Scientific Program	4.0
Consultants	21.6	Grants in Lieu of Taxes	2.2
Staff Relocation	10.6		
Administration	9.0		
Public Works	8.2		
Total	176.0	Total	15.2

* Includes \$4.9 million settlement by Public Works of the general contractor's delay claim. The resulting increase in the approved project budget remains subject to Treasury Board approval.

Exhibit 7.5
Estimated Total Project Costs

Source: Health Canada
and the Canadian Food
Inspection Agency

In our opinion, at the effective project approval stage, Treasury Board was not provided with a clear and comprehensive estimate of the project's total cost.

was not provided with a clear and comprehensive estimate of the project's total cost, which is currently approximately \$34 million in excess of the approved budget of \$141.8 million. As a result, ministers approved the project without having a realistic and complete picture of how much the facility would cost the Canadian taxpayer.

Project team philosophy of “build [up] to budget” provided no incentives for cost savings

7.59 Similar to most other major Crown projects we have examined, the project team followed a “build [up] to budget” philosophy for project development purposes. While this approach aims to ensure that the overall budget is not exceeded, it provides no incentives to pursue potential cost savings and deliver a project below budget where possible. The project team is ultimately accountable only for staying within the total Treasury Board-approved budget, regardless of whether the budget eventually proves to be in excess of need. For instance, there are many estimates for contingencies built into the approved budget that may not be required, but they are not accounted for and reported separately to ensure their cost-effective use. Design reserves, contract contingencies, inflation and risk allowances represent large pools of funds that we believe need to be approved, tracked and accounted for separately from the base budget.

7.60 Public Works officials acknowledged the reality that many projects are designed to budget. They believe that this approach should be changed, but that this will require a change in culture. Public Works is currently looking at how fees are identified and paid, and at what stages in the contract they are paid. It believes that contracts must be structured in a way that provides incentives for cost savings. The contracts for this project do not provide

incentives to the consultants to reduce costs, as their fees were based on a percentage of the construction costs. We support Public Works' efforts to reform its contracting practices with a view to providing incentives for identifying potential cost savings and delivering projects below budget where possible. However, Public Works officials acknowledge that appropriate controls need to be in place to ensure that cost savings are not achieved at the expense of program delivery and do not result in increasing the total life cycle cost of the project.

7.61 The Treasury Board Secretariat should clarify the precise nature and extent of activities that approved project budgets are intended to finance. The Secretariat and departments should also stress the achievement of best value in procurement decisions and develop incentives to encourage underspending of budgets where possible.

Treasury Board Secretariat response: The Treasury Board policy regarding project approvals includes a cost objective, an estimate of the total resources to be approved by the Treasury Board and needed to implement the project. It has been and will continue to be an objective of the Treasury Board review of departmental submissions to ensure that departments have included all costs to implement the project in the budget approval sought.

The objective of the Treasury Board policy on contracting is “to acquire goods and services and to carry out construction in a manner that enhances access, competition and fairness and results in best value, or, if appropriate, the optimal balance of overall benefits to the Crown and the Canadian people.”

The Treasury Board Secretariat shall focus more on options to achieve cost savings within the overall budget when reviewing departmental submissions. For departments and agencies with capital budgets, affordability should drive their

investment strategies and value for money should be ingrained into their management philosophy.

The Secretariat does not believe that an incentive regime at the project level to encourage underspending of budgets would be an effective way to achieve savings. It would be difficult to envision an incentive regime that would not have a potential downside in the absence of a much more rigorous Treasury Board approval process than presently exists. For example, the Secretariat would be concerned that an incentive to share savings would lead to increased pressure to pad cost estimates and upscale design requirements, thereby increasing the potential to come in under budget by seeming to cut costs and generate design savings.

7.62 Public Works and Government Services Canada should revise its contracting practices to provide incentives for cost savings within approved budgets but without compromising project objectives. The Department should also ensure that the design reserves, contract contingencies, and inflation and risk allowances are approved, tracked and accounted for separately from the base budget.

Public Works and Government Services Canada response: Agreed. Public Works and Government Services Canada is currently identifying ways to introduce into the overall contracting process viable and meaningful incentives for reducing costs where feasible. Public Works will develop best practices and consider the workability of formalizing the reporting of changes in design reserves and contract contingencies.

Improved reporting of budget variances is required

7.63 An internal audit of the Winnipeg facility found, and our own work confirmed, that the budget components and amounts were often reallocated within

the approved budget. Moreover, we noted that actual costs were not reported in the same format as the project budget. While we recognize that budget funds need to be reallocated as more information becomes available, we believe that the source, justification and approval of these changes should be clear and well documented. For example, we noted that consultant cost increases totalling \$10.2 million were financed from within the approved budget, but it is not clear which budget elements generated the savings to finance those increases.

7.64 We noted that the project management team did not use a formal forecasting methodology to estimate potential future cost increases. It believed that because of the project's unique and complex nature, formal forecasting could not be implemented as a cost-effective and reliable management tool. In our opinion, the forecasting technique used by the project team was not adequate to address variances in budget and schedule. We noted that as early as 1996, the project team was reporting to deputy ministers and ministers that the project was ahead of schedule and on budget, while in our opinion it was at serious risk of being behind schedule and going over budget.

Non-compliance with Treasury Board policies

7.65 We noted several instances where Public Works had exceeded its spending authority and Treasury Board approval was granted retroactively. In one instance, we found that in June 1996 Public Works had exceeded Treasury Board payment authority by approximately \$500,000 before it realized its mistake. However, when seeking additional payment authority, the Department did not inform the Board that payments had already been made against the additional spending authority it was seeking.

7.66 We also noted a lack of project progress reporting and inadequate reporting of project costs to Treasury

Our main concern is the accuracy and completeness of statements in various Treasury Board submissions.

Board. We are concerned with the lack of semi-annual reporting on the progress of a major Crown project, as required under Treasury Board policies. Our main concern, however, is the accuracy and completeness of statements in various Treasury Board submissions, such as those justifying project cost increases; they appear to be inconsistent with our audit evidence.

7.67 The Treasury Board Secretariat should ensure that departments submit project progress reports as required by Treasury Board policies on the management of major Crown projects.

Treasury Board Secretariat response: The Treasury Board Secretariat supports this recommendation. While an earlier policy required semi-annual progress reporting, it has since been revised to require reporting at pre-defined key milestones of a project. This would result in better reporting. Ultimately, responsible departments and ministers are accountable for the work to be performed and the expected results to be achieved in a manner consistent with the policy and the Treasury Board approval. Corrections and adjustments to plans may be necessary along the way. In situations where authorities need to be adjusted, departments are responsible for pursuing corrective action and seeking necessary Treasury Board approvals.

Project Management and Control Framework

Two internal audits identified concerns about early project management practices

7.68 A private sector firm, commissioned by the two client departments, completed two internal audits of the Winnipeg project and issued reports in November 1992 and June 1996. Both reports focussed on the appropriateness of the project's management and control framework.

7.69 The first report recommended, among other things, improving budgeting practices, defining and controlling contingency reserves, and strengthening the design review process. The report also noted the lack of incentives to reduce costs below the Treasury Board-approved budget.

7.70 The second report followed up on the status of recommendations raised in the first report and noted that the majority of them had been addressed only partially or not at all. It recommended that the project team demonstrate that Health Canada's Laboratory Biosafety Guidelines had been incorporated into the design of the new facility and that the presence of the client departments' expertise on site be consistent with the importance of the construction activities to follow. The report also noted that there were no agreed, realistic construction schedule and commissioning monitoring plan, and that the construction monitoring and verification agreement was based on an unapproved construction schedule. The report reiterated the recommendation to improve budgeting, forecasting and reporting practices.

7.71 We found that management had fully addressed the recommendation to demonstrate the linkage of the design to the biosafety guidelines, and had addressed to various degrees many of the other recommendations. Some recommendations were deemed retrospective and not useful to completing the project.

Consultant selection and management practices require improvement to mitigate risks of increased costs

7.72 In December 1986, the Minister of Public Works approved a list of seven firms to submit proposals to program and design a new high-containment laboratory and office building for Health Canada in the National Capital Region. The facility would accommodate the LCDC and the Bureau of Biologics. In May 1987,

proposals from all seven firms were formally evaluated by a Public Works committee and a winning proposal was selected. We were not able to review the evaluation committee's ranking of the proposals because the documentation was no longer available.

7.73 In September 1987, before the contract was formally awarded, a decision was made to move part of Health Canada's project to Winnipeg, Manitoba. It was also decided that Agriculture's requirement for a new virus laboratory, originally planned for Nepean, Ontario, would be included in the new Winnipeg facility. Some project officials believed that these decisions had significantly changed the scope of the project. They were concerned that the appointment of the original contractor, selected for a fundamentally different project, could be seen as undermining the fairness of the consultant selection process. Other officials believed that despite the change in project scope and cost, the overall intent of the new project was similar to the original project; any recall of proposals would be time-consuming and would increase costs to both the Crown and the consultants involved.

7.74 Given the nature and magnitude of the scope change, and the high risk that awarding the contract on the basis of a fundamentally different project could be seen as compromising the fairness of the consultant selection process, we believe the Project Steering Committee did not sufficiently justify the decision not to retender the commission.

7.75 For large and complex projects such as the Winnipeg project, we would have expected the consultant agreements to be tailored to take into account contractual issues specific to the project. Instead we found that, consistent with its policy at that time, Public Works used its standard departmental consultant agreement, developed for the "normal" situation of a smaller project managed by

a consultant from one office with subconsultants of its choice, usually in close proximity to the prime consultants. Throughout the project there were contract disputes between Public Works and the prime consultants, and at times with subconsultants, over issues that had not been set out clearly in the consultant agreement and that resulted in additional costs. Examples included:

- lack of definition of what constituted the approved construction cost estimate on which the consultant fees were based;
- unclear methodology to calculate consulting fees on contingency fund items;
- lack of definition of what constituted design errors and omissions;
- interpretation of the clauses on travel time and consultant location; and
- interpretation of whether certain fees were based on the contractor's unapproved shorter schedule or on the schedule set out in the contract.

7.76 Exhibit 7.5 details the estimated project costs. The cost of consulting services, including Public Works fees and departments' administration costs, totalled \$38.8 million. We believe that these costs are high, as they represent about 38 percent of construction costs or 31 percent of the combined construction and equipment costs. Project officials agree that the costs are higher than expected and attribute the increase to several factors. Programming and construction delays required more on-site personnel for longer periods than planned. Extensive travel was required by a great many consultants and project staff, from offices in six cities across the country. The decision by Health Canada to hire separate consultants to review the work of the prime consultants also added significantly to the costs of consulting services.

7.77 In our view, several million dollars could have been saved by:

For large and complex projects such as the Winnipeg project, we would have expected the consultant agreements to be tailored to take into account contractual issues specific to the project.

We believe that several million dollars could have been saved on this project.

- locating full-time project staff in Winnipeg;
- eliminating the need to hire additional consultants to review the work of the prime consultants; and
- strengthening contractual agreements to take into account contractual issues specific to the project.

7.78 Public Works and Government Services Canada should ensure that consultant contracts are tailored to the specific project, and should improve its monitoring of contractor performance.

Public Works and Government Services Canada response: Since 1993, PWGSC has adopted a new standard by substantially revising the consultant's contract form in consultation and co-operation with professional associations. These contracts are tailored to different types of work, consistent with professional standards, while allowing the flexibility to individualize the scope of the work to adapt to the specifics of the project. PWGSC continues to review the standard consultant agreement to allow further tailoring to specific project circumstances.

Project governance, team “chemistry” and turnover rates adversely affected project delivery

7.79 A key ingredient for success is the establishment of a focal point for leadership with appropriate authority and accountability, at the beginning and throughout a project. Multi-department projects require participants to accept that they are a team working for the achievement of overall government objectives. Trust and respect for individual roles and responsibilities are necessary for team building.

7.80 We found that the management and control framework and practices contributed, in part, to the project team's inability to prevent or to resolve more

effectively some of the problems experienced on the project, including cost overruns and construction delays. The decision-making process was made more difficult and complex on this project because there were two client departments whose program requirements and preferred options frequently did not coincide. This often led to negotiation and debate before agreement to proceed was reached.

7.81 We noted several instances where the client departments had difficulty agreeing on how best to resolve problems; in the early stages, lack of teamwork among project staff was the pervasive working environment. Exhibit 7.6 provides one example of difficulties encountered in reaching consensus, in this case deciding on the most appropriate autoclave (sterilizer) unit. We also noted, however, that teamwork and co-operation improved significantly from mid-1995, when Health Canada reorganized its project management staff and approach.

7.82 The prime consultants noted that there were divergent viewpoints among the client departments and Public Works on matters of project scope, design and operations. In our view, the project began without a sense of commitment by all parties, which often manifested itself in disagreements and lack of teamwork.

7.83 Although Public Works is the contracting authority responsible for delivering the project, Health Canada felt the need to spend \$1.6 million on a separate consultant to review the project brief, design documents and contemplated change notices. The situation frustrated Agriculture, Public Works and the prime consultants because it slowed progress and created an atmosphere of second-guessing matters for which the separate consultant was not ultimately responsible. We were informed that very few of the recommendations from the separate consultant had been implemented in the project.

In our view, the project began without a sense of commitment by all parties, which often manifested itself in disagreements and lack of teamwork.

7.84 The Project Steering Committee was responsible for the overall direction and conduct of the project. At the outset, it comprised three assistant deputy ministers, one from each of Health Canada, Agriculture and Public Works. In July 1995, the Committee was enlarged to five assistant deputy ministers, two from Health Canada and one each from Agriculture, the Canadian Food Inspection Agency and Public Works, to better reflect facility management issues. We noted that, over the life of the project, 13 different members have served on the Committee for terms of two to three years each. In our view, the high turnover rate and the need to make decisions by

consensus diffused project accountability. We believe that this lack of continuity and accountability in the management and control framework contributed at least in part to the inadequate defining of project cost and construction schedule, and to the number and large dollar values of claims on this project.

7.85 In future projects with more than one client department, the Treasury Board Secretariat should ensure that a single authority is established as the lead authority to represent the interests of all client departments and to be held accountable for the project results, as intended in

In 1992 the autoclave (sterilizer) requirements and specifications were the subject of many meetings and reviews by the project staff, including the prime consultants. In the tender documents issued in May 1993, two firms were identified as acceptable sources of autoclaves. The general contractor's bid included Firm A as its subcontractor for autoclaves. However, in January 1994 Firm B protested to Public Works that it should have been awarded the subcontract, alleging that Firm A's equipment did not meet the contract specifications.

In April 1994, the consultants providing separate advice to Health Canada throughout the project issued a report detailing concerns about the decision to use Firm A's equipment, stating that the Firm A autoclaves did not meet the essential criteria for laboratories at biosafety levels 3 and 4.

The prime consultants complained that they were spending an excessive amount of time responding to false accusations and innuendo about the Firm A equipment, and that for two years they had been unable to get Health Canada to specify which features were required on the autoclaves. They also noted that the specifications were written to allow for the two autoclaves to compete on an equal basis, as requested by the client departments, and that despite all the concerns, Health Canada had yet to issue a formal request to have Firm B's equipment supplied.

Public Works advised the client departments that the prime consultants had reviewed the shop drawings for Firm A's equipment and concluded that it did meet the specifications. Public Works requested that Health Canada acknowledge the following:

- Rejection of the Firm A equipment was a Health Canada requirement to meet safety concerns, and the Firm B equipment constituted a sole source to meet these requirements.
- Firm A might claim for losses since its equipment had initially been identified as acceptable, and these costs would have to be borne by Health Canada.
- Only autoclaves in Health Canada's space would be supplied from Firm B.

Health Canada never formally responded to this request.

The Public Works project manager sought direction from the Project Steering Committee to resolve the difference of opinion between Health Canada and the prime consultants. The Project Steering Committee decided in favour of the original contractor (Firm A). The net result of these events was to create acrimony among the project team and delays in arriving at a consensus.

Exhibit 7.6

Case Study – Autoclaves

**the Treasury Board policies for
managing capital projects.**

***Treasury Board Secretariat response:** The Treasury Board policy intends that a single authority be established for management and accountability purposes. Complex organization structures and joint ventures may require steering committees to ensure that the interest of multiple parties are considered during the conduct of large projects. In these situations, dispute mechanisms may be put in place to assist in the resolution of disputes and facilitate the efficient and effective conduct of the project by the lead authority.*

***Health Canada, Agriculture and Agri-Food Canada, Public Works and Government Services Canada and Canadian Food Inspection Agency response:** It is the view of the three departments and Agency that Canadians can be proud of this world-class facility, which reinforces Canada's established reputation as a leader in science and will put Canada at the forefront of human and animal health. The project management team successfully responded to the significant challenges of managing a highly complex and unique project over a ten-year period that included the planning and solution required to accommodate three building code upgrades; the need to satisfy all levels of government approvals; adapting to not only staff turnover but significant organizational changes at the departmental level; evolving programs; and rapid advances in technology.*

**Better management of change orders
would have reduced costs to the Crown**

7.86 As with any complex project, adjustments were made to the plans, specifications and contracts in place. These changes were implemented through the mechanism of contemplated change notices and change orders; an approved change notice becomes a change order. Work carried out through change orders is

usually more expensive because it is not subject to competitive bidding, and it generates significant administrative markups when multiple suppliers are involved. Contract changes also increase the risk that additional costs will be incurred in the form of delay claims.

7.87 We noted that change orders were funded from two sources, a contingency fund of \$7.2 million and a cash allowance of \$12.2 million. The cash allowance formed part of the general contractor's contract and was intended to purchase certain items that were known to be required but for which actual detailed requirements could not be determined prior to the contract award, such as laboratory casework and equipment and controls. Thirty-one change orders totalling \$10.5 million were issued against the cash allowance. For contract changes financed from the contingency fund, 926 change notices were raised, of which 677 were issued as change orders, costing \$7.6 million; 179 were cancelled and 70 remain to be resolved.

7.88 We found that change orders were generally well administered; they were well documented, logged and controlled and the performance of the work was verified prior to payment. However, many of the change orders were poorly managed. Many of the contemplated change notices took a long time to be approved as change orders; several took over 10 months and two took 22 months to resolve. In some instances, we noted that changes in the specifications contributed to the delay in approving the contract changes and resulted in added costs. In many other cases, delays were due to the large difference between the price estimated by the prime consultants and the price quoted by the general contractor, differences that in our sample averaged 330 percent with two cases over 2300 percent.

7.89 Delays and changes also led to unproductive payments. In one case, delays in obtaining client approvals

resulted in “bioseal” doors costing \$148,000 more than originally quoted. In another case, disagreements between the clients over whether some autoclave units needed to be modified resulted in \$71,000 in additional costs to store and modify units already in production.

7.90 The classification of changes as “errors and omissions” has been problematic for Public Works on many projects. The standard Public Works consultant agreement states that “the Consultant shall not be entitled to payment in respect of costs incurred by the Consultant in remedying errors and omissions in the services that are attributable to the Consultant, the Consultant’s servants or agents, or persons for whom the Consultant had assumed responsibility in performing the Services.” The agreement, however, does not provide a definition of “errors and omissions”. Public Works has taken the approach that errors and omissions apply to any change notice or change order issued to correct a problem that stems from the lack of co-ordination between the architectural and engineering disciplines during the development of the plans and specifications; or to incomplete details or unworkable details. In such cases, no fees are paid.

7.91 The prime consultants claim that they have never accepted Public Works’ designation of “errors and omissions” and believe that a fairer designation would be “design continuation”; they are claiming approximately \$400,000 in additional compensation. They argue that no sets of plans and specifications are perfect and it is unreasonable to expect them to produce error-free documentation for any project, particularly large projects on the scale of the Winnipeg laboratories.

7.92 In our opinion, there was a need to resolve major disagreements over what constitutes an error or omission instead of allowing them to continue throughout the project, since the Crown’s leverage with

the consultants normally diminishes as the project progresses.

7.93 In consultation with architectural and engineering associations, Public Works and Government Services Canada should clearly define what constitutes design errors and omissions, assign responsibilities for each, and incorporate the definition and responsibilities in project contracts.

Public Works and Government Services Canada response: Agreed.

Equipment requirements and costs poorly supported and purchases made in advance and in excess of need

7.94 Capital equipment is an integral part of the operations that will be carried out in the new Winnipeg laboratories. In the project approval documents, the departments estimated the cost of equipment purchases at approximately \$23 million, but the project budget identified only \$18.5 million. The remaining \$4.5 million was identified by Health Canada as money that will be required when operations begin in Winnipeg and existing equipment has reached the end of its economic life. At the end of our field work, the departments had acquired equipment for the Winnipeg facility costing approximately \$25.2 million.

7.95 We were informed that all requests for equipment were reviewed and challenged to ensure that only needed equipment was purchased. However, the departments were unable to provide us with documentation or analysis to support their initial estimates of equipment requirements. We found that Agriculture had overestimated its equipment budget by about \$1.7 million, intending to use the excess as a project contingency. It is not clear why Health Canada did not include its total equipment requirements in the project budget. We noted, however, that the total value of equipment purchased by Health Canada is now over double the

The classification of changes as “errors and omissions” has been problematic for Public Works on many projects.

amount planned. We therefore conclude that the Department did not adequately plan and budget its equipment requirements.

7.96 We noted several instances of purchases made in excess of need and in advance of need, totalling over \$2 million. Exhibit 7.7 provides an example of equipment purchased in excess of need. We also noted that between January 1996 and March 1997, Health Canada purchased equipment totalling \$1.9 million that is currently being stored in Ottawa and Winnipeg.

Commissioning

Commissioning was generally well managed, but scheduling created problems and added costs to the Crown

7.97 Commissioning is a sequential method of testing and validating results against expected performance criteria for all building components and equipment, systems and integrated systems. The commissioning process involved a three-tiered review by on-site personnel (Tier 1), independent technical and regulatory experts (Tier 2), and a committee of international experts in human and animal health (Tier 3).

7.98 The budget for the construction monitoring and verification program was \$5.3 million. It was based on the general contractor's May 1994 proposed

construction schedule that identified 30 June 1996 as the interim acceptance date. The actual total cost of the program to date is not known, because separate accounts were not established to capture and report these costs in the same way as they were budgeted.

7.99 At the end of our field work, integrated systems tests had been completed for the majority of the Canadian Food Inspection Agency's portion of the facility, with satisfactory results. Management has informed us that subsequent to our field work it expects to complete all commissioning by April 1998.

7.100 We noted that the Public Works commissioning team has been involved in all aspects of test validation and system acceptance. The team has gained first-hand experience working with the systems and received technical support and training from the prime consultants and the general contractor. Many of the team members are now responsible for operating and maintaining the facility.

7.101 Management has informed us that all staff will be trained in laboratory procedures and the safe handling of organisms and equipment before work begins in the laboratories. Once the laboratories are operating, the facility's safety and environmental services office will be responsible for monitoring programs, staff procedures and laboratory

Exhibit 7.7

Case Study – Waste Disposal Unit

The original specifications in the general contractor's contract included an incinerator, at an estimated cost of \$1.1 million, that would be used to incinerate all waste from laboratories prior to local disposal. We were advised that during a cost-cutting exercise the general contractor stated that an incinerator could be purchased for \$700,000. In the end, a compactor with an attached shredder and autoclave was purchased in place of the incinerator, at a cost of \$410,390.

The use of an incinerator had originally been specified to reduce any public concerns over waste disposal from the facility. The requirement was subsequently reduced to a waste compactor, with an added autoclave. The waste compactor unit is located outside the laboratory containment area, and protocols require that all materials be decontaminated prior to leaving the containment area. Therefore, there is no apparent requirement for an autoclave as part of this waste handling equipment. We were advised that the purpose being served requires only a straight waste compactor, which could have been leased for an annual cost of approximately \$7,200.

maintenance to ensure that all safety requirements continue to be met.

7.102 Overall, we found that the commissioning program was generally well managed. We noted, however, that the decision to schedule the commissioning program on the basis of an unapproved construction schedule created inefficiencies, as tests had to be postponed and rescheduled, and resulted in the transfer of contractor responsibilities and costs to the Crown.

Conclusion

A successful, complex project, but stronger management practices would have reduced costs to the Crown

7.103 We conclude that this unique laboratory facility meets, and in some cases exceeds, the client departments' stated requirements. Health Canada and Canadian Food Inspection Agency officials have expressed a high level of satisfaction with the facility. They believe that once fully staffed, the facility will enable them to carry out their mandated programs safely and to be at the forefront of human and animal disease research.

7.104 Capital projects commit the Crown to large one-time capital expenditures and often to even greater ongoing operating and maintenance costs over the life of the asset. It is crucial that departments provide Treasury Board with the best possible estimate of total project costs before a project becomes irrevocably committed. It is equally important that the Treasury Board approval of projects indicate what is being approved clearly enough that senior management can be held accountable for project results. In this project, we noted weaknesses in both these areas.

7.105 We noted a number of instances in which Treasury Board policies and approvals were not respected, and in which the project was not implemented

with due regard to economy and efficiency. Information provided to Treasury Board for approving and monitoring this major Crown project fell short of that required in Treasury Board policies. The project was initiated without a proper needs and options analysis. The organizational framework and decision-making processes to manage this complex project contributed to costly delays and a turbulent project management environment. In our opinion, these factors led to diseconomies totalling from at least \$5 million to \$10 million.

Achieving full potential from this expensive world-class facility remains a challenge

7.106 At the end of our field work, many key scientific staff positions had yet to be filled. In addition, the client departments will be operating in a new area as they begin training their professional staff in level 4 laboratory procedures, a first-time experience in Canada. Furthermore, the testing of all systems and integrated systems must be completed successfully as part of the commissioning phase before the laboratories can be made operational, or "go hot". Any serious delays in achieving these milestone events would constitute a major setback for the departments, requiring the continued operation of parallel facilities in the National Capital Region to ensure program response capability.

7.107 The client departments will also need to address the issue of optimizing the use of the facility's laboratory space, which currently exceeds planned occupancy, including considering cost-recovery opportunities.

7.108 This is the first facility in the world to combine laboratories concerned with both human and animal diseases. The facility should provide increased potential for scientific solutions by having health and animal specialists working in partnership in a single facility. The

Overall, we found that the commissioning program was generally well managed.

We conclude that this unique laboratory facility meets, and in some cases exceeds, the client departments' stated requirements.

co-location of the two functions has probably also resulted in cost savings over the construction of two separate facilities.

7.109 Once the laboratories are fully functioning, however, potential program issues may present a challenge. While there should be opportunities for synergy and co-operation between the

departments, the competing functional priorities that gave rise to difficulties during the design and construction of the facility may serve to limit the achievement of these benefits. We will continue to monitor the efforts of senior management to ensure that in operation, these new facilities achieve their full potential.



About the Audit

Objectives

The objectives of the audit were to determine whether the constructed laboratory facility meets the client departments' stated requirements and the Treasury Board policies and approvals for the project, and whether the project was implemented with due regard to economy and efficiency.

Scope

We examined the major aspects of the design and construction of this major Crown project from the perspective of the generally accepted phases of good project planning and implementation. Specifically, we reviewed the needs definition and statement of requirements, options analysis, project definition and approval, design and contracting, construction and commissioning phases. The commissioning phase had not been completed by the end of our field work.

Our audit was not designed to conclude on whether the Winnipeg laboratories are safe but rather on the extent to which the project team could demonstrate that they are, and that the Health Canada Laboratory Biosafety Guidelines were fully addressed in the design and construction of the facility. This includes the establishment of a formalized process for the review and sign-off of biosafety issues by the appropriate competent authorities. We also reviewed the roles and responsibilities of Health Canada's Office of Biosafety and Agriculture and Agri-Food's Biohazard Containment and Safety Unit.

Criteria

Our audit criteria were derived from the established methodologies of this Office for auditing capital asset projects and from the Treasury Board policies for managing major Crown projects. Health Canada's Laboratory Biosafety Guidelines and Agriculture and Agri-Food Canada's Containment Standards for Veterinary Facilities provided the criteria for assessing biosafety issues.

Approach

We interviewed most of the key departmental program and project officials and reviewed relevant project files and documents. Our field work included site visits to the new Winnipeg laboratories, Health Canada's existing facilities in Ottawa and Winnipeg, Agriculture's/the Canadian Food Inspection Agency's existing laboratories in the National Capital Region, and visits to the U.S. Centres for Disease Control and Prevention in Atlanta, Georgia and the U.S. Department of Agriculture Foreign Animal Disease Diagnostic Laboratory at Plum Island, New York.

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Report of the Auditor General of Canada to the House of Commons – 1998

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Report of the
Auditor General
of Canada
to the House of Commons

Chapter 8
Department of Finance – Effectiveness
Measurement and Reporting

April 1998

**Report of the
Auditor General
of Canada
to the House of Commons**

Chapter 8
Department of Finance – Effectiveness
Measurement and Reporting



April 1998

This April 1998 Report comprises 9 chapters and a Foreword and Main Points. In order to better meet clients' needs, the Report is available in a variety of formats. If you wish to obtain another format or other material, the Table of Contents and the order form are found at the end of this chapter.

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Cat. No. FA1-1998/1-8E
ISBN 0-662-26796-6

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Chapter 8

Department of Finance —
Effectiveness Measurement and
Reporting

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies and practices of the Office of the Auditor General. These policies and practices embrace the standards recommended by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. The numbered paragraphs in bold face represent recommendations.

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Department of Finance —

Effectiveness Measurement and Reporting

Main Points

8.1 In addition to functions that include preparing the Budget and providing economic policy advice to the government, the Department of Finance has responsibilities related to a number of policies and programs. The Department's 1997–98 planned expenditures of \$66 billion account for 43 percent of planned federal expenditures. The Department is also responsible for federal tax policy, including preferential tax provisions that are intended to lead to the achievement of a variety of government policy objectives.

8.2 The significance of the Department's policy and program responsibilities underlines the importance of its obligation to make known to Parliament and to the public, in a clear and meaningful manner, the nature and extent of those responsibilities, the objectives involved and the results achieved relative to those objectives.

8.3 Improvement is required in providing Parliament with clear and consistent statements of objectives and of the Department's policy and program-related responsibilities. For many policies and programs, the Department shares responsibilities with other departments and agencies. We found a general lack of clarity in documents directed to Parliament about the other departments and agencies involved and the manner in which responsibilities are shared.

8.4 We found gaps in reporting to Parliament on results achieved relative to objectives. Our findings in this audit are consistent with the findings of a number of audits of individual policies and programs undertaken by this Office over the past six years. The picture that emerges is one of known shortcomings, and insufficient attention to measuring effectiveness and reporting results to Parliament and the public.

8.5 Legislative provisions governing a number of the Department's policies and programs have been the subject of review by Parliament to consider whether the provisions should be changed to improve performance and to enable policies and programs to be adapted to new circumstances. Such legislative reviews are valuable in their own right; they are not, however, a substitute for systematic measurement and reporting of effectiveness information by the Department. We believe legislative reviews would be enhanced by Parliament having more regular and timely access to information on the results that policies and programs have achieved.

8.6 Planning for effectiveness measurement and reporting is not sufficiently linked with the Department's corporate planning process. The Department's current approach results in an effectiveness measurement function that is partial in coverage and not clearly integrated with the overall corporate management structure. In view of the limited resources allocated specifically to the function, we are concerned about the Department's capacity to meet its obligations to account to Parliament for results achieved.

Introduction

The Department of Finance plays a pivotal role within the government

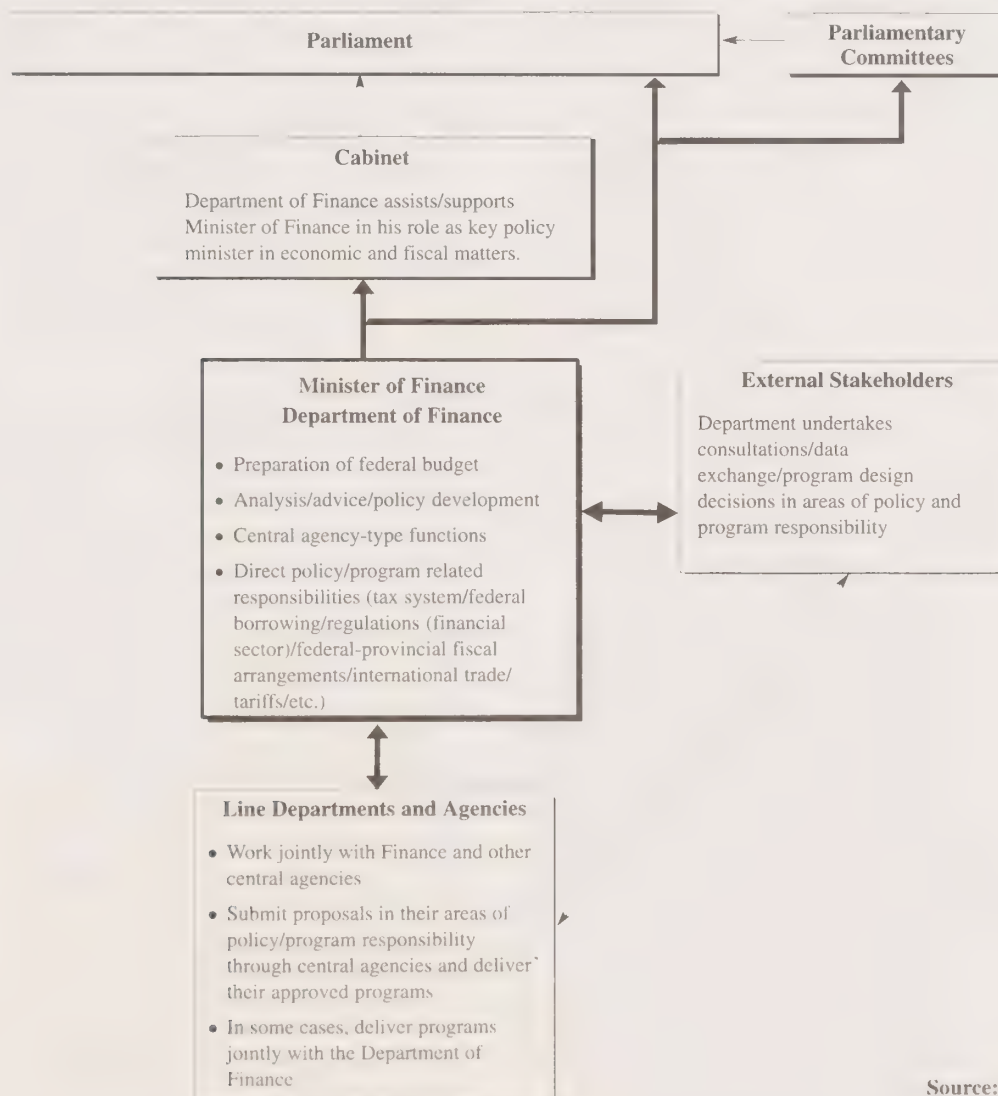
8.7 The Department of Finance operates under sections 14–16 of the *Financial Administration Act*. These provide the Minister of Finance with the broad responsibility for “the management of the Consolidated Revenue Fund and the

supervision, control and direction of all matters relating to the financial affairs of Canada not by law assigned to the Treasury Board or to any other Minister.” The roles and responsibilities of the Department are outlined in Exhibit 8.1.

8.8 As the exhibit indicates, a basic function of the Department is to assist and support the Minister of Finance in his role as the key policy minister for economic and fiscal matters. The Department

Exhibit 8.1

Roles and Responsibilities of the Department of Finance



Source: Office of the Auditor General

provides this assistance and support in the context of the Minister's Cabinet responsibilities and accountability to Parliament.

8.9 The Department plays a central, strategic role within the federal government. Its functions include preparing the Budget and providing economic policy advice to the government. The Department exercises central agency functions in the oversight and co-ordination of those activities of departments and agencies that affect the economy. In addition to its policy advisory and central agency roles, the Department has a number of direct responsibilities related to policies and programs. These responsibilities carry the concomitant obligation to account to Parliament for results achieved relative to established objectives. The Department's planned expenditures of \$66 billion account for 43 percent of planned federal expenditures of \$152 billion for 1997–98.

The Department has direct responsibilities related to a number of policies and programs

8.10 The Department's direct responsibilities for policies and programs relate to such matters as their design, supervision, management or implementation. In some cases, the responsibilities are shared with other federal departments; in others, the Department shares responsibility or works closely with provincial and territorial governments. It is the direct policy and program-related responsibilities of the Department, as distinct from its central agency, Budget and policy advisory roles, that are the focus of this audit.

8.11 Exhibit 8.2 outlines areas where the Department has direct policy and program-related responsibilities. It also identifies cases where those

responsibilities are shared with other departments. The policy and program areas listed in Exhibit 8.2 cover a wide range of activities and account for a very substantial level of expenditure, most of it statutory. Statutory expenditures are authorized by the Act of Parliament that establishes the program, but are not subject to annual scrutiny and review as part of the parliamentary supply process.

8.12 The most substantial of the expenditure programs relate to the management of the public debt, with an estimated budget of \$46.0 billion for 1997–98, and the Federal-Provincial Transfer Payments program, with an estimated budget of \$19.4 billion and a further \$12.6 billion in tax transfers. Transfers under various statutory authorities include equalization payments, the Canada Health and Social Transfer and a variety of other transfers to provincial and territorial governments.

8.13 Among the Department's other policy and program-related responsibilities are those related to the regulatory framework for the Canadian financial services sector, and representation of Canada's interests in various international organizations, including the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development. In addition, the Department plays a central role in the development, management and implementation of Canadian international trade and investment policy. Among other things, the Department leads or directs the government on import policy, in particular on tariff and trade remedies, and is responsible for related domestic legislation and regulations.

8.14 The Department is responsible for the development and evaluation of federal taxation policies and legislation,

It is the direct policy and program-related responsibilities of the Department, as distinct from its central agency, Budget and policy advisory roles, that are the focus of this audit.

Exhibit 8.2

Areas Where the Department of Finance Has Direct Policy and Program-Related Responsibilities

Policy/Program Area	Budget/Expenditures	Responsibilities Shared With:
Public Debt Management	<ul style="list-style-type: none"> 1997–98 budget of \$46.0 billion (includes interest and other costs)¹ 	Bank of Canada
Federal-Provincial Transfer Payments Program	<ul style="list-style-type: none"> 1997–98 budget of \$19.4 billion¹ an additional \$12.6 billion is provided in tax transfers 	Health Canada Human Resources Development Canada
International Trade and Investment Policy	<ul style="list-style-type: none"> 1997–98 budget of \$2.4 million ² 	Foreign Affairs and International Trade Canada Revenue Canada
International Financial Organizations	<ul style="list-style-type: none"> 1997–98 budget of \$694.3 million ¹ 	Canadian International Development Agency
Regulatory Framework: Canadian Financial Services Sector	<ul style="list-style-type: none"> 1996–97 expenditures were \$1.8 million 	Office of the Superintendent of Financial Institutions Canada Deposit Insurance Corporation Bank of Canada
Federal Tax System	<ul style="list-style-type: none"> 1997–98 budget of \$10.3 million (does not relate to the value of tax revenue) 	Revenue Canada
Canada Pension Plan (joint responsibility of federal and provincial governments)	<ul style="list-style-type: none"> Funded by direct premium revenue 	Human Resources Development Canada Office of the Superintendent of Financial Institutions Revenue Canada Public Works and Government Services Canada
Privatization	<ul style="list-style-type: none"> Responsibility transferred from Treasury Board Secretariat in June 1997 Annual budget \$0.3 million (estimate) 	
Special Program (payments to fund Canada's equity interest in Hibernia)	<ul style="list-style-type: none"> 1997–98 budget of \$58.0 million 	
Domestic Coinage (production and shipment of coins)	<ul style="list-style-type: none"> 1997–98 budget of \$38.0 million 	Public Works and Government Services Canada Royal Canadian Mint

¹ With minor exceptions, these expenditures are statutory.

² Budget of the International Trade Policy Division of International Trade and Finance Branch.

Source: 1997–98 Estimates Part III for Department of Finance and Human Resources Development Canada; documentation provided by Department of Finance

Effectiveness measurement involves examining the extent to which government policies, programs and operations are achieving their objectives.

including various preferential tax provisions. Many of these provisions reduce corporate and personal tax liabilities. By providing assistance or incentives to targeted groups of individuals and businesses, the provisions are intended to lead to the achievement of specific objectives (including goals in areas such as social, cultural, economic and regional policies). These so-called “tax expenditures” include provisions such as tax exemptions, deductions, deferrals and tax credits.

8.15 Finally, the Department has certain responsibilities under the Canada Pension Plan (CPP). The CPP is a joint responsibility of the federal and provincial governments and is funded by its own direct premium revenue. Changes to benefits, to the rate of contributions, or to investment provisions require an Act of Parliament and supporting orders-in-council from at least two-thirds of the included provinces, representing at least two-thirds of the population of all included provinces. The Department is responsible for leading negotiations with the provinces, and all other aspects of the statutory reviews that result in recommendations for changes to the CPP. In the past, the Department has also been responsible for the administration of the CPP Investment Fund. As of April 1998, the CPP Investment Board is responsible for investing new CPP funds in a diversified portfolio of securities, although the Department remains responsible for the administration of the existing portfolio of loans to the provinces and (with provinces) for the legislative framework for CPP investment policy.

8.16 In view of the extent and consequences of the Department’s policy and program responsibilities (involving a variety of instruments such as transfers, legislation, regulation and selective tax

measures), effectiveness measurement and reporting are crucial. Information on results is needed to account to Parliament and Canadians for what has been achieved relative to established objectives, as well as to help improve future performance.

The need to measure and report effectiveness is embedded in government policy

8.17 Effectiveness measurement involves examining the extent to which government policies, programs and operations are achieving their objectives, as well as identifying other positive or negative effects. As we emphasized in our 1996 Report (Chapter 3: Evaluation in the Federal Government), information about the “bottom line” of government activity requires, among other things, disciplined measurement and analysis of effectiveness. In practice, a variety of approaches can be used, including, for example, evaluations conducted by evaluation or review units, reviews led or mandated by senior management or by program managers, and analyses of information from the ongoing monitoring of policies, programs or operations.

8.18 The government has embedded in policy the need for information on results to support decisions, improve the way government works and provide accountability. The 1994 Treasury Board Manual on Review, Internal Audit and Evaluation (Review Policy) seeks to ensure that the government has timely, relevant and evidence-based information on the performance of its policies, programs and operations, and that it uses this information to improve their management and cost-effectiveness as well as to account for results.

8.19 Under the Review Policy, deputy heads of departments are accountable for, among other things, ensuring that departmental programs and policies are

functioning as intended, that appropriate review mechanisms are being used, and that review information is used in decision making and accountability reporting.

8.20 The improvement of information on performance to aid decision making and facilitate accountability is a key feature of the government's revised expenditure management systems. As well, in his 1996 Annual Report to Parliament (*Getting Government Right: Improving Results Measurement and Accountability*), the President of the Treasury Board strongly emphasized the importance of evaluating the actions of government and reporting publicly on the results (see Exhibit 8.3).

Parliament and the public expect reporting of information on results

8.21 Canadians expect the government to spend tax dollars wisely and report on results achieved. Surveys of public opinion show that the availability of results information influences the

confidence that citizens and taxpayers have in their governmental institutions.

8.22 Public reporting of effectiveness information also serves Parliament in the exercise of its scrutiny and legislative functions. The government develops initiatives and undertakes expenditures subject to the approval of Parliament. Public accounting for the results achieved with the expenditures and authorities approved is a vital step in parliamentary control. This requires making the objectives of policies and programs, and the results achieved relative to those objectives, known to Parliament and to the public in a timely and meaningful manner. The information needs to be clear, concrete and understandable, and accessible to all parliamentarians. Although individual accountability documents cannot always include all the information that might be appropriate, they can provide clear references to other sources.

8.23 Parliament has maintained its interest in results information. As we

Public accounting for the results achieved with the expenditures and authorities approved is a vital step in parliamentary control.

Annual Report to Parliament by the President of the Treasury Board, *Getting Government Right: Improving Results Measurement and Accountability*, 1996. The report stated:

The government must equip itself with better systems for evaluating its actions so that it can genuinely answer for these actions, first and foremost to Canadians, who are both clients and taxpayers. This is the only way government can evaluate and debate the merits of the decisions it makes every day on the public's behalf.

Standing Committee on Procedure and House Affairs, *The Business of Supply: Completing the Circle of Control*, Sixty-Fourth Report, April 1997. Among other things, the report stated:

Debt and deficits, the fewer resources available to governments, and debate as to how these resources should be best applied as well as about the proper role for government all figure prominently in the public discourse of the day. Canadians expect their Parliament will play a central role in these debates by exploring alternative policy options, holding government and its bureaucracy accountable, educating the public while respecting and representing its views and concerns, and, at the end of the day, being at the table when difficult choices are made.

Performance documents should include status reports on ongoing evaluations conducted on new and existing programs, including those involving statutory expenditures, as well as reports on evaluations that have been completed. In particular, evaluations must articulate objectives, address the question of whether or not the objectives are being met, whether the program is being efficiently managed, and whether there are alternative means of achieving the objectives.

Exhibit 8.3

Public Reporting of Effectiveness Information Is Required by the Government and Expected by Parliament

noted in Chapter 3 of our 1996 Report, the Standing Committee on Public Accounts reaffirmed its interest in program evaluation in its November 1994 Sixth Report. Further, a recent report of the Standing Committee on Procedure and House Affairs (The Business of Supply: Completing the Circle on Control, April 1997) emphasized that effectiveness information is central to many of the key public debates of the day (Exhibit 8.3).

Focus of the audit

8.24 Our audit objectives were:

- to determine the extent to which the Department of Finance undertakes effectiveness measurement and reports publicly on the achievement of objectives in those areas where it has direct responsibilities related to policies and programs; and
- to determine the extent to which the Department has the capacity, structures and procedures to measure adequately and report publicly on the effectiveness of its policies, programs and operations.

8.25 The scope of our audit included components of all the policy and program areas identified in Exhibit 8.2, with the exception of those related to privatizing certain Crown corporations, to the Special Program (payment of Canada's equity interest in the Hibernia oil development), and to Domestic Coinage (costs of production and shipment of coins). In the case of the federal tax system, we focussed on tax expenditures.

8.26 In 1993, at the request of the Standing Committee on Public Accounts, we carried out a special audit of changes that had been introduced in the organizational approach to effectiveness measurement in the Department's Tax Policy Branch (The Revised Approach to the Evaluation of Tax Measures at the

Department of Finance, March 1993). Our 1993 audit concluded that evaluations produced by the Branch under the new organizational approach met established measurement and analysis standards for the evaluation questions they addressed, whereas evaluation studies under the old organization did not consistently do so. We also found that important questions were addressed in the studies produced under the new approach.

8.27 We raised concerns, however, regarding the approach of the Tax Policy Branch to establishing priorities for effectiveness measurement. We also noted that fewer resources were being dedicated to evaluations and urged that an adequate effectiveness measurement capacity be maintained within the Branch. Our findings in 1993 were tentative because the organizational changes were recent. The present audit was therefore designed to follow up on the observations we reported in 1993.

8.28 Further details about the approach and scope are presented at the end of the chapter in **About the Audit**.

Observations and Recommendations

Accountability to Parliament for Results

8.29 To assess the extent to which the Department meets its obligation to account to Parliament for results, we sought to determine whether, in material available to Parliament, the Department clearly identifies the policies, programs and operations for which it is accountable (including the nature and extent of its accountability); states their objectives clearly and consistently; and reports the results achieved.

Improvement in communicating responsibilities to Parliament is required

8.30 We examined a range of public documents produced by the Department, each of which could reasonably be regarded as authoritative for purposes of reporting to Parliament (Estimates documents, federal budget papers, White Papers and annual reports). Our purpose was to assess the clarity of information regularly available to Parliament about the Department's responsibilities, including how they relate to those of other departments and agencies with responsibilities in the same policy and program areas.

8.31 We found that the Department's statements of its own responsibilities were not clear in two of the areas we examined. In addition, where responsibilities are shared with other departments and agencies, we found a general lack of clarity about the organizations involved and the manner in which responsibilities are shared among them.

8.32 The Department shares responsibilities with other departments and agencies in many of the policy and program areas we included within the scope of this audit. In none of these areas, however, do the documents we reviewed consistently identify the other organizations involved or how their responsibilities relate to those of the Department of Finance. As a result, the accountability frameworks for these policy and program areas are not always clearly communicated to Parliament.

8.33 The failure to articulate clearly the accountability frameworks for the policies and programs we reviewed was particularly evident in Estimates documents. For example, although the Department shares some responsibilities

with Foreign Affairs and International Trade Canada and Revenue Canada in the development, management and implementation of Canadian trade and investment policy, its 1997–98 Estimates documents make no mention of this. We recognize that there are limitations on the amount of information that can be provided in any one document. However, we believe that, as a minimum, identification of the departments and agencies involved, with cross-references to other sources of related information, is essential to provide Parliament with a clear perspective on accountability.

8.34 One of the two cases where we noted that statements of the Department's own role were not clear relates to Finance's responsibilities for the Canada Pension Plan (CPP). We found that the Estimates documents provide only limited information on the Department's responsibilities. In addition, they do not make any reference to the fact that information on the nature and extent of the Department's responsibilities can be found in the CPP annual report.

8.35 The other case where we found that Parliament did not receive clear information about the Department's responsibilities relates to the regulatory framework for the financial services sector. The 1997–98 Estimates documents indicate that the Department is responsible for "the functioning of and regulatory framework for Canadian financial markets and institutions." Although the Department acknowledges its responsibility for policy development related to the functioning of Canadian financial institutions, as well as for the regulatory framework that applies to them, it does not in fact have responsibility for the broad functioning of financial markets. The Department told us that it intends to clarify the statement of its responsibility

Accountability frameworks for policy and program areas where the Department shares responsibilities with other departments and agencies are not always clearly communicated to Parliament.

An essential requirement for accountability to Parliament is that departments identify clearly the objectives of program expenditures and other initiatives.

in this regard in future Estimates documents.

8.36 The Department of Finance should ensure that the information it provides regularly to Parliament clearly and consistently identifies its own responsibilities, the departments and agencies with which it shares responsibilities and the manner in which the responsibilities are shared.

Department's response: The Department already does this. The 1998–99 Main Estimates provide more substantial information on the CPP as suggested. In addition, the audit suggests that the role of the Department in CPP is not well known. However, the Department's role has been made clear in documents, speeches and even a special web site. There were statements in every Budget presented to Parliament starting in 1994; a special CPP web site was created (winter 96); a Report on Consultations was published (June 96); a federal/provincial agreement was reached on measures to make the CPP sustainable, followed by a speech in Parliament and the tabling of draft legislation (February 97); and finally, legislation was introduced, a new actuarial report was tabled in Parliament, and a press release was issued summarizing the bill (September 97). Further, the recently concluded federal/provincial review included a number of measures to significantly improve information reporting and stewardship for the CPP.

Parliament needs better information on objectives

8.37 An essential requirement for accountability to Parliament is that departments identify clearly the objectives of program expenditures and other initiatives when seeking Parliament's approval for them in appropriation or other Acts. Clear objectives, consistently stated, provide a firm and transparent

basis for public debate and decisions. Similarly, they greatly aid parliamentarians and the public in subsequently assessing the results achieved.

8.38 It is important here to distinguish between operational objectives and policy or program objectives. The Department's operational objectives may vary from year to year — for example, in dealing with specific intentions or targets in planning, consultation or negotiation related to some aspect of policy development or program implementation. Although such information is useful in identifying operational activities to be performed and milestones to be reached, it is the policy or program objectives (the things to be accomplished as a result of the policy or program) that are central to establishing the basis for accountability to Parliament. It is in relation to these objectives that Parliament needs information on results.

8.39 We examined a range of public documents to determine whether they provide Parliament with good information on policy and program objectives. It is important for objectives to be articulated not only clearly, but also consistently across information sources.

8.40 We found that objectives were both clear and consistently stated for the Public Debt program, the Federal-Provincial Transfer Payments program and the International Financial Organizations program.

8.41 With respect to international trade and investment policy, we examined the Department's Estimates documents, the Departmental Outlook, the Federal Regulatory Plan, and the publication titled Finance Canada — Structure and Role. With the exception of some recent Estimates documents, which made limited reference to "improving Canadian competitiveness" through a variety of

specific policy reform and consolidation measures, none of these documents included any statements of objectives for the international trade and investment policy responsibilities of the Department.

8.42 We noted that the Estimates documents contain neither information on program objectives for the Canada Pension Plan nor directions to other sources where such information is available. The Estimates documents also do not provide statements of objectives for the regulatory framework for the financial services sector. In addition, we found that two public documents issued by the Department (Enhancing the Safety and Soundness of the Canadian Financial System, February 1995; and 1997 Review of Financial Sector Legislation: Proposals for Changes, June 1996) do not provide clear statements of the objectives of the regulatory framework.

8.43 The Department provides Parliament with a special annual report on tax expenditures. Our findings on that report are presented in paragraphs 8.62–8.64.

8.44 The Department of Finance should provide Parliament with clear and consistent statements of objectives for the full range of its policy and program-related responsibilities.

Department's response: The Department already does this. However, it agrees that, wherever feasible, it will examine its procedures and provide more public information on the broad policy objectives and the extent to which they are being met.

Insufficient attention to providing effectiveness information to Parliament

8.45 The Department told us that effectiveness information has regularly been reported to Parliament in its

Estimates documents, Budget papers, government White Papers or through other means. We examined the documents identified by the Department, including its pilot Performance Report for the period ending 31 March 1997. We assessed the documents against the basic requirement that effectiveness information should address the extent to which programs are achieving their objectives.

8.46 We found significant gaps in the public reporting of results relative to objectives in all the areas included within the scope of our audit. In most cases, reporting focussed on specific areas of operational activity or progress, but did not provide information on the achievement of objectives.

8.47 In the Department's 1997 Performance Report, the information provided for the Public Debt program went furthest in reporting on program effectiveness. In this case too, however, some additional information would have strengthened the report. For example, the report describes indicators of the efficiency of Canada's financial markets and states that Canada's performance in terms of those indicators compares favourably to that of other countries with highly developed capital markets. We believe the report would have been more useful had it included the actual measurements — including comparisons with other countries, and changes in those measures over time.

8.48 The Department told us that it did not provide detail in the Performance Report because it is a summary overview of performance. It noted, however, that more detail had been provided in recent Debt Operations Reports. In these circumstances, a reference to the additional detail in Debt Operations Reports would be essential to assist readers of the Performance Report.

We found significant gaps in the public reporting of results relative to objectives.

Our findings about deficiencies in effectiveness measurement and reporting are consistent with the findings of previous audits undertaken by this Office.

8.49 Where programs are subject to legislative review, we found that some information on results is generated in that context. However, based on an examination of three reviews, we have concluded that legislative reviews do not eliminate the need for the Department to undertake systematic and disciplined measurement and reporting of effectiveness. Indeed, we believe the timely reporting of effectiveness information would help inform public and parliamentary debate and enhance the legislative review process (paragraphs 8.76–8.96).

8.50 The findings of our current audit about deficiencies in effectiveness measurement and reporting are consistent with the findings of a number of audits undertaken by this Office from 1992 to 1997. The policy and program areas examined in these earlier audits cut across a wide range of the Department's responsibilities.

8.51 Summary findings relating to effectiveness measurement and reporting from these earlier audits are outlined in Exhibit 8.4. At the time the audits were undertaken, there was only one case — the management of the public debt — where we were able to report that an evaluation was under way.

8.52 The situation regarding the effectiveness measurement of tax expenditure provisions is more positive. Although a number of the audits outlined in Exhibit 8.4 identified shortcomings in measuring the effectiveness of tax expenditures, during the current audit the Department identified a range of initiatives it believes to be related, in whole or in part, to effectiveness measurement. However, in view of the materiality and the importance of the objectives of many tax expenditures, we concluded in this case too that providing

accountability information to Parliament on the extent to which objectives have been achieved deserves more attention. A more detailed discussion of the Department's approach to measuring and reporting the effectiveness of tax expenditures is presented in paragraphs 8.59–8.75.

8.53 In assessing the Department's commitment to measuring and reporting effectiveness, we also reviewed the Department's submission in the 1997 Annual Report to Parliament by the President of the Treasury Board (Accounting for Results, October 1997). Among other things, that report is intended to identify the results that government departments are committed to providing for Canadians as well as the methods they will use to demonstrate the results achieved.

8.54 We noted in Chapter 5 of our 1997 Report (Reporting Performance in the Expenditure Management System) that the Report of the President of the Treasury Board is an important step in providing accountability information to Parliament. The value of the information, however, depends on the nature of the results commitments and indicators proposed. We found that the results commitments of the Department of Finance in the 1997 President's Report are very general in nature (for example, "secure social programs"). Moreover, the means by which the results are to be demonstrated do not speak clearly and unambiguously to achievements related to policy or program objectives. For example, the Department's commitment to secure social programs is to be demonstrated by "implementation of new programs" and "improvements to existing social programs".

8.55 **The Department of Finance should review the priority it assigns to**

accounting to Parliament for the effectiveness of its policies and programs and take steps to address the shortcomings we have identified.

Department's response: The Department already makes great efforts to achieve this objective. As the Department's overall response at the end of the chapter makes

Exhibit 8.4

Findings from Earlier Audits and Studies on Effectiveness Measurement Activities, 1992–1997¹

Year	Audit/Study	Effectiveness Measurement and Reporting	Audit/Study Findings
1997	Federal-Provincial Transfers (Equalization Program)	Insufficient	"...little information is regularly provided to Parliament on the workings of the Equalization Program....The Department of Finance's Part IIIs have not reported to Parliament on the way the program works or on its performance."
1996	Goods and Services Tax: New Housing Rebate	Insufficient	"An evaluation of the New Housing Rebate Program is needed."
1996	Federal Debt Management	Five-year evaluation under way	"The debt managers... have not yet been able to develop appropriate methodology to enable them to assess...whether and how well they have succeeded in achieving their primary objective....Such an assessment is not a simple task....We recognize that there are a number of challenges and constraints to developing a meaningful methodology...."
1996	Evaluation in the Federal Government	Sizeable coverage	The audit found that the Management of Public Debt program had received sizeable evaluation coverage.
1996	Excise Duties and Taxes on Selected Commodities	Insufficient	"...the Department has no current plans to evaluate any commodity tax...."
1996	Child Tax Benefit and Goods and Services Tax Credit Programs	Insufficient	"Neither program is a priority for evaluation."
1995	Regulatory Framework – Deposit-taking Institutions	Insufficient	"...there has been no comprehensive evaluation for the regulatory framework to see whether it has been effective in meeting the objectives."
1994	Tax Assistance for Retirement Savings	Insufficient	"Evaluation studies do not address key results and other issues of major concern."
1994	Income Tax Incentives for Research and Development	Insufficient	"At the time of our audit, no formal evaluation of the tax incentives for research and development had been done."
1992	Department of National Revenue—Customs and Excise – <i>Special Import Measures Act</i>	Insufficient	"...Finance, the department responsible for policy and legislation... has not completed a formal evaluation of the program since the Act came into force in 1984."

¹ In addition to these regular program audits, in 1993 we undertook a special audit of effectiveness measurement within the Tax Policy Branch. That audit and the current audit identified nine tax measures that have been evaluated during the 1990 to 1997 period.

Source: Office of the Auditor General

clear, the report is misleading in its conclusions on the Department's efforts. The Department undertakes reviews, analysis, and ongoing monitoring, and publishes a wide range of evaluations in a variety of forms, such as Budgets, consultation papers, press releases, regular reports, etc. The audit ignores this and, instead, focusses only on a narrow range of publications in order to conclude that effectiveness reporting is lacking. In fact, effectiveness reporting, like effectiveness measurement, is a large part of the Department's mandate and a key priority. If the wide range of publications produced by the Department were examined for effectiveness measurement, it would be apparent that the Department does, in fact, give priority to accounting to Parliament for the effectiveness of its programs and policies.

The audit ignores the fact that decisions always have to be made given a very real resource constraint and that, even with the best will in the world, it is not possible to continuously evaluate, in a formal sense, all policy and make this supply of information on effectiveness measurement public. The audit fails to examine whether, given this constraint, an increase in

formal evaluation studies would provide the best "value for money" for Canadians.

8.56 Effectiveness information can support accountability and change. A legislative review of the Canada Pension Plan in 1996 showed that a number of major deficiencies had evolved over time. As Exhibit 8.5 indicates, among the changes proposed were strengthening the program's stewardship, as well as accountability to Parliament and to the public.

8.57 We examined two additional cases (one within the Department of Finance and the other within Human Resources Development Canada) where there was evidence of benefits accompanying the measurement and reporting of effectiveness. The results, as outlined in Exhibit 8.6, suggest that effectiveness information was a contributing factor in bringing about changes in program design and subsequent policy development.

8.58 In both case examples — the Cape Breton Investment Tax Credit (evaluated by the Department of Finance's Tax Policy Branch), and the former

Exhibit 8.5

Stewardship and Accountability for the Canada Pension Plan

- The Canada Pension Plan (CPP) provides contributors and their families with a basic level of protection against loss of earnings due to retirement, disability or death of a contributor to the program. Estimated disbursements for 1997–98 are \$17.8 billion.
- In February 1997, the government released *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP*. The report stated:
 - economic and demographic realities have changed significantly over the years without adequate response (by CPP);
 - enrichments to benefits have repeatedly been made without proper adjustments to contributions; and
 - administrative procedures have strayed from the intent of the legislation.
- The government called for the stewardship and accountability for the Plan to be strengthened. Among other things, the government noted, "annual reports ... tabled in Parliament will be more complete in the information they provide, and will in particular explain how administrative problems are being addressed."
- A legislative review of the CPP in 1996 led to major changes to the Plan in the legislation passed in 1997.

Source: Human Resources Development Canada and Department of Finance

Unemployment Insurance Program (evaluated by Human Resources Development Canada) — effectiveness measurement and reporting were accompanied by significant developments affecting the programs. These developments in large part reflected, or were consistent with, the directions indicated by the effectiveness information that had been produced. It is worth noting that in both cases the information was publicly reported and was subject to considerable public scrutiny and debate.

Parliament needs better information on the objectives and results of tax expenditures

8.59 As noted earlier, tax expenditure provisions have been established under the federal tax system to promote the achievement of government policy objectives, including social, cultural, economic and other goals. The provisions range, for example, from tax relief from the Goods and Services Tax covering basic groceries to tax breaks for corporations to promote certain types of investments and tax breaks for individuals to encourage retirement savings.

Exhibit 8.7 provides further examples of tax expenditures.

8.60 Using the tax system to deliver government programs provides for less control over program and resource use than using direct government expenditures. Management procedures, including effectiveness measurement, need to recognize and respond to this characteristic. In addition, the need to report results to Parliament merits particular attention because the process of parliamentary control and accountability for tax measures differs from other government programs.

8.61 Tax expenditure provisions are not subject to regular annual scrutiny and debate as are those programs that go through the parliamentary supply process. Neither are they automatically subject to periodic legislative reviews. The enabling legislation for tax measures does not normally contain sunset provisions. Specific tax expenditure provisions are usually introduced as part of the Budget and result in later amendments to the *Income Tax Act*.

Tax expenditure provisions are not subject to regular annual scrutiny and debate as are those programs that go through the parliamentary supply process.

Exhibit 8.6

Examples of Public Reporting on Program Effectiveness

Department	Program	Budget	Key Effectiveness Results Reported to Parliament	Program Change
Department of Finance	Cape Breton Investment Tax Credit	Over \$500 million in forgone taxes	1990: Of \$2.1 billion in investment funded under the program, more than 80 percent would have occurred anyway (without program assistance).	Preliminary findings were among factors considered in decision not to extend the tax credit.
Human Resources Development Canada	Unemployment Insurance	\$17.6 billion (1993–94)	1994: Program strengths and weaknesses were identified, including negative program design features influencing worker/employer behaviour and increased unemployment effects. ¹	New legislation (1995) <ul style="list-style-type: none"> – clarified objectives – provided formally for regular program evaluation – strengthened reporting – revised program structure

¹ In addition to the Department's evaluation, we undertook a study of the program, which we reported to Parliament in 1994.

Source: Office of the Auditor General

The tax expenditure report does not provide information about the specific objectives that each provision is designed to achieve.

8.62 Annual reports on tax expenditures. In recognition of these characteristics, the Department of Finance publishes annually a list of tax expenditures, along with estimates of the tax revenue forgone for each one. We noted that this report has not been published on a regular basis. Of the past five reports, two were published in August, two in December and one in February. We believe that a regular publication schedule, co-ordinated with the cycle of the expenditure management system, would enhance the report's potential as an accountability vehicle for Parliament.

8.63 The Department's annual tax expenditure reports provide historical estimates, based on a sample of taxpayer returns and other statistical data, of a range of individual tax measures that the Department indicates could be considered to be tax expenditures. The 1997 report

provides historical data for various periods, depending on the tax system and the last year for which data are available. For the personal income tax system, data are provided for 1992, 1993 and 1994; for the corporate income tax system, for 1992 and 1993; and for the Goods and Services Tax, from 1992 to 1995. In addition, the report provides projections, beyond the last historical year, to 1999.

8.64 The tax expenditure report includes descriptions of the many provisions, and, in the case of the personal tax system, categorizes them in a way that gives a broad indication of their area of impact (for example, employment, education, income maintenance and retirement). The report does not, however, provide information about the specific objectives that each provision is designed to achieve. Moreover, the report provides no information on the effectiveness of tax measures in achieving their objectives. The Department told us that it is planning to change the nature of the tax expenditure reports to include information from evaluations and analyses of tax measures, and that it is considering including the specific objectives of each tax expenditure in the 1998 report.

8.65 Objectives of tax expenditures. We found that the objectives of some of the tax expenditure provisions we examined in more detail were not clear. The Department states that tax expenditures are put in place to achieve a variety of economic, social and other objectives. We therefore expected to find that the Department would have identified their objectives in these terms, as well as the manner in which they could be expected to contribute to the policy objectives concerned. Among the 15 specific provisions we examined, we found cases where objectives were not clearly stated.

Exhibit 8.7

Examples of Tax Expenditure Measures

Category	1997 Projected Value (\$ million)
Personal Income	
– Registered Retirement Savings Plans	
• Tax Deductions for Contributions	6,540
• Non-Taxation of Investment Income	5,180
– \$500,000 lifetime capital gains exemption for small business shares	685
Corporate Income	
– Low tax rate for small businesses	2,620
– Scientific research and experimental development investment tax credit	965
GST	
– Basic groceries	2,850
– Rebates for municipalities	565

Source: Department of Finance, Government of Canada Tax Expenditures, 1997

8.66 For example, the Department told us that there is no public statement of formal objectives for the non-taxation of employer-paid private health and dental benefits. In the case of the Goods and Services Tax rebates for municipal bodies and related boards and commissions, the Department stated that the purpose is to provide continuity in the exemptions from sales tax under the previous federal tax system. In our view, this provides no indication of the actual results to be achieved by the rebates or of linkages to the government's wider policy objectives.

8.67 The Department of Finance should:

- **identify clear objectives for each tax expenditure in terms of its intended contribution to economic, social or other objectives;**
- **report the objectives to Parliament in the annual report on tax expenditures;**
- **report summary effectiveness information in the annual report on tax expenditures where available; and**
- **establish a schedule for publishing the annual report on tax expenditures that complements the expenditure management cycle.**

Department's response: With respect to the specific objectives of tax expenditures, the Department will include these in the 1998 tax expenditure report, which we anticipate will be published in the spring of 1998.

Regarding the publication of summary effectiveness information, it is anticipated that the tax expenditure report will include further analysis and evaluation of specific tax expenditures and summary effectiveness information. It should be recognized that such analysis and reporting does not need to be done on an annual basis since most tax expenditures are not changed from year to year.

With respect to the need for regular publication of the report on tax expenditures that is co-ordinated with the cycle of the expenditure management system, the Department agrees and plans to publish the tax expenditure report in the spring of each year.

8.68 Measuring the effectiveness of tax expenditures. The Department's 1997 tax expenditure report indicates that there are more than 150 provisions that could reasonably be regarded as tax expenditures. The annual revenue costs of individual provisions range widely, from a few million to many billions of dollars. In light of such differences, as well as differences in their purposes, we recognize that not all the tax expenditure provisions warrant the same degree of attention in terms of effectiveness measurement and reporting.

8.69 The Tax Policy Branch told us that it uses a variety of techniques that contribute to effectiveness measurement. In addition to carrying out some in-depth evaluations of specific provisions, the Branch monitors the operation of individual provisions on an ongoing basis and undertakes internal analyses and assessments of issues brought to its notice through sources that include individual taxpayers, parliamentary committees, Revenue Canada and the Department of Justice. These analyses result in many changes to the tax system each year.

8.70 Other techniques include external reviews. For example, in 1996 the Department established a Technical Committee on Business Taxation. The Committee's mandate is far-ranging, including assessing the fairness of business taxation and considering ways in which it might contribute more to job creation and economic growth. As the Committee's work was still under way when we completed this audit, we were unable to determine the extent of the

The output of tax expenditure evaluations has been modest, but the Tax Policy Branch has recently taken action to increase the level of effort devoted to effectiveness measurement.

contribution it will make to measuring the effectiveness of tax expenditures.

8.71 Accounting to Parliament for the achievement of objectives. We recognize the importance of external reviews, as well as the ongoing monitoring and adjustment of tax measures to deal with operational problems as they arise. We do not believe, however, that these activities are sufficient to fulfil the Department's obligation to account regularly to Parliament and Canadians for the results achieved relative to the policy objectives established for specific tax expenditures. In our view, reporting on the achievement of objectives is central to providing accountability to Parliament, and should not be limited to situations where the government has concluded that certain provisions need to be changed.

8.72 In this context, we assessed the extent of the information available to Parliament over the eight-year period 1990–97 on the achievement of the objectives of various tax expenditure provisions. We found that Parliament has received such information largely as a result of tax expenditure evaluations, and that the output of such evaluations has been modest. Over the 1990–97 period, only five tax expenditure evaluations were completed, and, when we completed our audit, two were under way. By way of comparison, we note that there are about 150 tax expenditure provisions, of which 14 involve more than \$1 billion annually in forgone tax revenue. Although the value of forgone tax revenue is not the only relevant criterion in this regard, it is frequently an important one.

8.73 The Department's view is that major studies or evaluations are generally only appropriate in situations where there may be concern about effectiveness. The Department notes that, based on the

application of a value-for-money criterion, it adopts a variety of approaches as problems are identified through the monitoring of tax expenditures. These approaches may range from immediate remedial action to major evaluations. The Department's position is that it publishes information in documents such as the Budget Plan, consultation papers and press releases on the effectiveness measurement and analysis that leads to proposed changes. The Department notes, however, that there are limits on the extent to which it is possible to provide background analysis in all cases.

8.74 Approach to effectiveness measurement. As described in paragraph 8.27, our 1993 audit of effectiveness measurement in the Tax Policy Branch raised concerns about the adequacy of the resources dedicated to the function. We note that the Branch has recently taken action to increase the level of effort devoted to effectiveness measurement. The Branch started 1997–98 with 6.6 full-time-equivalent staff and a contract budget of \$250,000 allocated to the function. During the year, four additional analysts have been hired. In addition, the Department told us that the approach to evaluation has been changed so as to produce a greater number of short-term evaluations (including, but not limited to, tax expenditure evaluations) that will allow more timely reporting of results and a better-informed public debate on tax policy issues. These are welcome developments.

8.75 Our 1993 audit of effectiveness measurement in the Tax Policy Branch also raised concerns about the adequacy of the Branch's planning process in targeting priority areas for effectiveness measurement. We reported at that time that the Branch had developed a set of criteria to help select particular areas for

effectiveness measurement but had not applied the criteria consistently and clearly. Our current audit confirmed that the criteria have been maintained, and that they were applied in developing the Branch's evaluation plans for the 1995–97 period. We noted, however, that the implementation of these plans had fallen significantly behind the schedules established.

Legislative review processes need to be complemented by systematic measurement and reporting of effectiveness

8.76 Legislative provisions governing some policies and programs are subject to periodic review by Parliament to consider whether provisions should be changed to improve performance or to enable policies and programs to be adapted to changing circumstances. In many (but not all) cases, legislative reviews occur when legislation contains “sunset” provisions that terminate the legislation (usually after a period of five years); this ensures periodic parliamentary scrutiny of the legislation and of the policies or programs involved.

8.77 Many of the Department's areas of policy and program responsibility have been the subject of legislative reviews. We examined three specific reviews. Our aim was to identify the extent to which, in the course of the reviews, the Department of Finance informed Parliament about the objectives of the policies and programs and the extent to which those objectives had been achieved by existing approaches.

8.78 The legislative reviews we selected were of the equalization component of the Federal-Provincial Transfer Payments program, the regulatory regime for Canada's financial sector and the *Special Import Measures Act*. In all cases, the review process involved parliamentary scrutiny of

proposals for change; we examined the effectiveness information that was available to support this parliamentary scrutiny.

8.79 Equalization. Chapter 8 of our 1997 Report (Department of Finance — Equalization Program) notes that little information is regularly provided to Parliament on the workings of the program. In particular, the Report states that the Department's Estimates documents have neither reported on the program's performance nor provided any indication of where parliamentarians can get such information.

8.80 As our 1997 Chapter 8 also notes, the review of equalization legislation is complicated by the provincial dimension. The process currently involves federal and provincial officials engaged in discussions behind closed doors, and there are concerns that Parliament is often not included in the deliberations in a timely fashion. The chapter calls for opening up this process for considering changes to such a complex, fundamental program by involving Parliament in a meaningful way.

8.81 The lack of regular reporting on program performance identified in our 1997 audit underlines the need for Parliament to receive information on program results within the context of the five-year cycle of legislative review and renewal. We therefore examined the information that the Department provided to Parliament to support the legislative review process leading to the 1994 renewal of the equalization legislation. We found that the information provided addressed some key aspects of the program's success in ensuring that provinces have sufficient revenue-raising capacity to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. We believe that supplementing such

One conclusion of our audit is that legislative review processes need to be supported by information on the achievement of program objectives.

information by considering a broader range of program effects (for example, possible inter-program effects in relation to other federal-provincial transfers) would further help support Parliament's involvement in the legislative review process.

8.82 Regulatory framework for the financial sector. We examined a range of documents to assess the role of effectiveness information in the legislative review of the regulatory framework for the financial sector. The material we examined included the recent audit work reported by this Office (Chapter 5, 1995 Report, Office of the Superintendent for Financial Institutions — Deposit-taking Institutions Sector), along with the Public Accounts Committee's report on that chapter and the Department's response. We also examined the Twenty-first Report of the Standing Senate Committee on Banking, Trade and Commerce (1995), and the Department's report (1997 Review of Financial Sector Legislation: Proposals for Change), along with relevant testimony and background documents.

8.83 Our 1995 Report indicated that although the government had produced several policy papers and reports dealing with different aspects of the regulatory framework, there had been no evaluation of the effectiveness of the framework to assess the extent to which its objectives had been achieved. In that Report, we noted that we had been unable to find a satisfactory answer to the question — Is the government achieving its objectives for the financial sector?

8.84 Following a hearing on our 1995 Report, the Standing Committee on Public Accounts in its Seventeenth Report, dated 20 November 1995, recommended that the government immediately carry out a comprehensive evaluation of the system for supervising and regulating federally

regulated financial institutions. This was to be in preparation for the review of the legislation in 1997.

8.85 In its response to the Public Accounts Committee, the Department agreed that it was important to assess the relevance and effectiveness of existing systems and programs. However, the Department advocated a consultative review of the legislation rather than a program evaluation. It noted that, among other things, such a review would examine in more general and judgmental terms the effectiveness of the complex policy regime for the financial services sector than would a program evaluation. In addition, the Department stated that the complexity and rapid evolution of the financial sector would make it difficult to establish reliable empirical measures of the effectiveness of the regulatory framework. The Department also expressed the view that such measures of effectiveness would add little to the review process.

8.86 One conclusion of our audit is that, in terms of accountability to Parliament and Canadians in general, there is a strong case to be made for supporting legislative review processes with whatever information can be developed on the achievement of program objectives. This is so even if effectiveness measurement is not always able to produce definitive findings. In this case, we based our conclusion in large part on an examination of the Department's key report, 1997 Review of Financial Sector Legislation: Proposals for Change. This was an important consultative document in the context of the legislative review and represented the culmination of extensive prior work.

8.87 This report states that the message from the legislative review process is that the financial sector

legislation is generally working well. However, the report provides no direct evidence to support this conclusion. In particular, the report does not explicitly identify the objectives of the regulatory framework and does not provide direct information on the extent to which objectives are being achieved. As noted, the Department stated in its response to the Public Accounts Committee that the rapid evolution of the financial sector, coupled with the short time that the legislation has been in place, makes measuring the achievement of specific program objectives difficult.

8.88 In our view, without developing and reporting effectiveness information to the extent possible, it is equally difficult to conclude as positively as the Department has done about the legislation's success. We believe it would be difficult for Parliament to assess the reliability of such a positive conclusion without clear evidence of the extent to which the objectives of the regulatory framework established under the legislation are being achieved, or an indication as to why such information cannot be provided.

8.89 The Department had in fact provided a preliminary assessment of the extent to which the regulatory framework was meeting its objectives in a background document to the deliberations of the Senate Standing Committee on Banking, Trade and Commerce. However, the Senate Committee concluded in its 1995 report that it was not possible to be certain at that point about the extent to which the regulatory framework was successful in achieving its objectives. The Department told us that its background material was instrumental in facilitating the Committee's deliberations and in shaping additional background work for the 1997 review of the legislation. We

believe the Department's report on the 1997 review would have been more useful, both as a consultative document and as a means to provide accountability to Parliament, had it explicitly identified the regulatory framework's objectives and directly addressed their achievement.

8.90 The Department continues to be of the view that, because of the array of competing factors in the environment in which financial institutions and financial markets operate on a daily basis, the efficiency and effectiveness of the regulatory framework for the financial sector cannot be measured by evaluating discrete regulatory policies. It firmly believes that the sunset clauses in the financial institution statutes, which ensure that legislative reviews are conducted every five years, are the best mechanism to keep Parliament informed of the performance of the financial sector in relation to broad policy objectives. The Department notes that these reviews involve widespread consultations with stakeholders who provide considerable feedback on how the broad policy objectives are being met and what areas need to be addressed.

8.91 In December 1996, the Minister of Finance announced the establishment of a Task Force on the Future of the Canadian Financial Services Sector. This initiative is part of the government's effort to ensure that the regulatory framework for the sector keeps pace with the changing environment in which it operates. The Task Force's enquiries extend broadly to the public policies affecting the sector and its report is to be submitted to the Minister of Finance by September 1998. At the present time, therefore, the extent to which its work will involve measuring and reporting on the effectiveness of the current regulatory framework is not known.

8.92 The Special Import Measures Act. The *Special Import Measures Act* (*SIMA*) provides for the application of anti-dumping and countervailing duties on dumped or subsidized imports that are found to cause material injury to domestic producers. The Act was subject to legislative review in 1996 by the House of Commons standing committees on Finance and on Foreign Affairs and International Trade.

8.93 The decision to proceed with a legislative review was prompted, in part, by the findings from Chapter 19 of our 1992 Report, Department of National Revenue — Customs and Excise — Special Import Measures Act. In that audit, we noted that the Department of Finance, the department responsible for policy and legislation, had not completed an evaluation of the program since the Act came into force in 1984. We pointed out the need to measure the impacts and effects of the *SIMA* program, including both positive effects and possible negative effects, such as the extent to which protection may be detrimental to consumers, possibly increasing production costs and the ultimate prices of consumer goods. We recommended, among other things, that the Department complete a formal evaluation of the import policy framework. In its response published in our Report, the Department agreed with the recommendation.

8.94 In view of the Department's commitment, in this audit we examined background material prepared by the Department of Finance to assist the parliamentary committees during the 1996 legislative review. We found that the Department had provided a wide range of material, including some relating to the experience of other countries, with respect to the incidence, design and

implementation of special import measures. As part of this material, the Department discussed the general impacts of these trade remedies, but provided no measurement of the actual extent of the impacts on Canadian consumers or on the Canadian economy as a whole.

8.95 Our examination of the joint report of the parliamentary committees that carried out the 1996 legislative review showed that the process led to important assessments of the continued relevance of the program and ways in which its operational design could be improved. In terms of the recommendations we made in 1992, however, we believe the *SIMA* legislative review would have benefited further if the Department had addressed more directly the effectiveness measurement concerns we raised at that time. This would have provided Parliament with a clearer perspective on the impacts of the program. The Department indicated that the Minister chose to have the legislation reviewed by a parliamentary committee.

8.96 Our assessment of the three cases described above confirmed that legislative reviews have many strengths — including timeliness and transparency. We concluded, however, that they need to be complemented by specific effectiveness measurement and reporting processes. Separate processes are required to provide Parliament with timely information on the results that policies and programs are achieving relative to their objectives. In addition to serving accountability, we believe such information enhances the quality of legislative reviews by leading to better-informed public and parliamentary debate on performance issues and helping assess the need for change.

Effectiveness Measurement Capacity and Corporate Planning

8.97 As noted earlier, the findings of this audit and previous audits carried out by our Office point to insufficient attention being given to effectiveness measurement and reporting by the Department. We assessed the commitment to effectiveness measurement and to providing Parliament with accountability information on results by examining the recognition given to it in the Department's corporate planning and identifying the resources allocated to the function.

Effectiveness measurement is not sufficiently integrated with the Department's overall corporate planning

8.98 In organizations that manage for results, effectiveness measurement is usually closely linked with corporate planning for the organization as a whole. In this way, effectiveness measurement becomes a matter of concern at the highest levels within the organization. The findings of previous evaluations and reviews can be used to help develop the priorities and strategies set out in corporate plans. At the same time, plans and priorities for future effectiveness measurement efforts can be established consistent with overall corporate strategies and plans.

8.99 In the policy and program areas we examined, effectiveness measurement is not clearly identified as an element in the Department's overall corporate planning.

8.100 We found that only the Tax Policy Branch has made efforts to plan its effectiveness measurement activities systematically, taking account of the Department's upcoming corporate

priorities and the accompanying need for information on program results.

8.101 The Department of Finance should ensure that there are clear links between its overall corporate planning process and its effectiveness measurement function.

Department's response: It is already the case that effectiveness measurement is an overall part of the corporate planning process. Effectiveness measurement pervades the work of the Department and is intrinsic to what the Department does. In this way, the linkage between effectiveness measurement and the corporate planning process is established and maintained. This was demonstrated by examples such as the Tax Fairness document published as part of the 1996 Budget.

The Department's approach to effectiveness measurement needs to be strengthened

8.102 We are concerned about the Department's capacity to meet its responsibilities for effectiveness measurement and reporting. The Department has responsibilities for measuring and reporting on the effectiveness of federal tax policies as well as policies and programs involving \$66 billion in annual expenditures. We could identify, at most, about 14 full-time-equivalent staff, and less than \$300,000 in annual contract budgets, that were specifically allocated to effectiveness measurement.

8.103 We noted that in contrast with the Department of Finance, Human Resources Development Canada, with approximately \$55 billion in annual expenditure programs, currently has over 30 full-time-equivalent staff and approximately \$7 million in contract resources for effectiveness measurement. We recognize that any comparisons have

Effectiveness measurement is not clearly identified as an element in the Department's overall corporate planning.

to be treated with considerable caution because of differences in the nature of the policies and programs involved. However, we believe that the striking difference in resource allocation raises questions about the adequacy of the Department of Finance's capacity to measure and report on the achievement of objectives in those areas where it has direct policy or program responsibilities.

8.104 Clearly identified effectiveness measurement resources are currently located in two of the Department's branches — the Tax Policy Branch and the Financial Sector Policy Branch. In the former, specific full-time-equivalent staff resources are identified; in the latter, effectiveness measurement activities are carried out largely under contract. No resources are specifically allocated to effectiveness measurement activities in the three remaining policy and program branches. Two of these (Federal-Provincial Relations and Social Policy, and International Trade and Finance) have clearly identified policy and program responsibilities. The Federal-Provincial Relations and Social Policy Branch noted, however, that it devotes significant resources to reviewing the Canada Pension Plan and to assessing how accurately the Equalization Program formula measures provincial fiscal capacities — which it sees as a key indicator of the program's effectiveness.

8.105 Whatever the Department's capacity to plan and undertake effectiveness measurement, an equally important question is whether that capacity is organized within the Department to maximize its potential contribution.

8.106 We expected that the organization of the effectiveness measurement function would reflect its importance as a key tool for management

and for providing accountability to Parliament. As such, the function would be designed to ensure objective, independent and timely analysis, and would be organized in a way to sustain its role and importance within the overall departmental structure.

8.107 We found that the Department's current approach to effectiveness measurement results in a function that is partial in coverage and not well integrated with the overall corporate management structure. The function is clearly identifiable within only a limited number of the Department's policy and program branches that form the "front-line" of its activities.

8.108 Approaches to effectiveness measurement in other organizations.

For purposes of comparison, we looked at selected characteristics of some organizations where we were told that effectiveness measurement and reporting play prominent and positive roles. The organizations we selected were the World Bank, the International Monetary Fund and Human Resources Development Canada.

8.109 We selected the first two because of the key role that results information, analysis and reporting play in their operational activities. We included Human Resources Development Canada because the Department has announced that it is developing a results-driven accountability system.

8.110 In making comparisons between the effectiveness measurement functions in these organizations and the Department of Finance, we focussed on three areas: the organizational structure of the effectiveness measurement function; the attention given to effectiveness measurement in corporate planning; and the reporting of results.

8.111 The results of our analysis are summarized in Exhibit 8.8. All the comparison organizations, while diverse in nature, have a great deal in common with respect to how the function is treated.

8.112 In all three organizations, the effectiveness measurement function is comprehensive in its coverage and strategic in focus. Further, in each, the function reports either organizationally or functionally at the highest level within the organization. In contrast, we assessed effectiveness measurement in the Department of Finance as partial in program coverage, excluding important program areas, and not closely connected to the highest levels within the organization.

8.113 The Department's response to effectiveness measurement and reporting requirements is reactive rather than strategic. The Department has on occasion responded to audit findings concerning shortcomings in effectiveness measurement and reporting by indicating a willingness to undertake measurements in specific areas if directly requested to do so by Parliament. This response presupposes that Parliament can assess beforehand, and without adequate information, the degree of importance that should be accorded to various program or policy outcomes. In our opinion, this is unrealistic.

8.114 Further, as noted earlier, the function is not clearly identified as an element in the Department's overall corporate plans. In contrast, effectiveness measurement figures visibly in the corporate planning processes of the three comparison organizations and is a significant factor in their management and accountability regimes. There is increasing emphasis in these organizations on the reporting of results achieved relative to program objectives.

8.115 The Department of Finance should ensure that its approach to effectiveness measurement is consistent with the need to maximize its contribution to meeting the Department's obligation to account to Parliament for results.

Department's response: Both effectiveness measurement and reporting are part of the everyday work of the Department of Finance and are an essential part of the basic mandate of the Department. Work done in the Department that takes the form of analysis, review and ongoing monitoring (e.g. the Excise Act Review and the CPP Review) is ignored, even though the audit recognizes these as legitimate forms of effectiveness measurement. The Department prints evaluation information in a variety of forms, including Budgets, consultation papers, press releases, etc., but the chapter takes almost no account of these.

The Department's response to effectiveness measurement and reporting requirements is reactive rather than strategic.

Conclusion

8.116 The Department of Finance has wide-ranging policy and program responsibilities, involving tens of billions of dollars in expenditures and tax revenues. The significance and size of these policies and programs place particular importance on effectiveness measurement and reporting to provide accountability to Parliament and Canadians as well as to help improve program performance.

8.117 We found that systematic measurement of effectiveness relative to policy and program objectives, and public reporting to account for the achievement of objectives with the funds and authorities approved by Parliament are limited.

8.118 Priorities and plans for effectiveness measurement are not established within the context of the

Exhibit 8.8

Comparison of Approach to Effectiveness Measurement with Other Organizations¹

	Department of Finance	International Monetary Fund	World Bank	Human Resources Development Canada
Organizational Structure of Effectiveness Measurement Function	<ul style="list-style-type: none"> Partial Effectiveness measurement not a clearly identified function in most Branches Function does not report to Deputy Minister or to senior management committee 	<ul style="list-style-type: none"> Comprehensive/Strategic All operational groups undertake review of objectives achievement Further recognition of need for accountability and transparency with newly established evaluation unit reporting to Managing Director External evaluation as a "second opinion" 	<ul style="list-style-type: none"> Comprehensive/Strategic Operational groups subject to process evaluations reported to senior management Separate evaluation unit examines long-term impacts (work in progress); reports to Board of Directors 	<ul style="list-style-type: none"> Comprehensive/linked to "results driven accountability system" and legislative requirements Separate evaluation unit reports to senior management committee; does not report directly to Deputy Minister
Corporate Planning and Program Effectiveness Measurement	<ul style="list-style-type: none"> Effectiveness measurement not identified as an element of Corporate Business Plans Department states it will react if requested by Parliament to produce effectiveness results for specific programs but does not take initiative 	<ul style="list-style-type: none"> Central part of Corporate Planning 	<ul style="list-style-type: none"> Central part of Corporate Planning 	<ul style="list-style-type: none"> Important part of corporate planning through "results-driven accountability system"
Reporting of Results	<ul style="list-style-type: none"> Limited reporting 	<ul style="list-style-type: none"> Transparent reporting vis-à-vis Executive Board representing member countries 	<ul style="list-style-type: none"> Transparent reporting of operational effectiveness Growing focus on measurement/reporting of long-term impacts from programs 	<ul style="list-style-type: none"> Transparent reporting

¹ Information on the International Monetary Fund, World Bank and Human Resources Development Canada is based on published material and interviews. We did not carry out audit work in these organizations.

Source: Office of the Auditor General

Department's corporate planning process, and the resources allocated specifically to the function are limited. Overall, we found the function to be partial in coverage and not clearly integrated with the overall corporate management structure.

8.119 In view of government policy and Parliament's expectations for improved information on results, we believe that the Department needs to review the options available to it for strengthening effectiveness measurement and reporting and then select and implement the most appropriate option.

Department's overall response: *In responding to the conclusions of this audit, there are two general comments to be made.*

- *First, the Department does undertake a considerable number of evaluations but they are ignored because the audit takes much too narrow and mechanistic a view of what effectiveness measurement and reporting are. This is because of the audit's singular focus on so-called "formal evaluations" — detailed,*

longer-term, major research undertakings — to the virtual exclusion of any other type of effectiveness measurement, which could be relatively short, but equally effective. Examples of the latter are the analyses, presented in Budget chapters, underlying the basis for a change in policy.

- *Second, the audit raises the question of whether the Department should do more "formal evaluations". In answering that question, it must be recognized that to do so would require diverting resources away from other policy analysis and development and less formal evaluations. In striking the balance between "formal evaluations" and other critical work, the Department must be guided by the principle that Canadians must get "value for money". Disturbing this balance would imply going counter to this fundamental principle.*

As the examples in the Department's responses to specific recommendations in the chapter make clear, it would appear that a whole range of evaluations has escaped the attention of the auditors.



About the Audit

Objectives

The objectives of our audit were:

- to determine the extent to which the Department of Finance undertakes effectiveness measurement and reports publicly on the achievement of objectives in those areas where it has direct responsibilities related to policies and programs; and
- to determine the extent to which the Department has the capacity, structures and procedures to measure adequately, and report publicly, on the effectiveness of its policies, programs and operations.

Scope

Our scope included components of all the Department's major policy and program areas except those that relate to privatizing certain Crown corporations, to the Special Program (payment of Canada's equity interest in the Hibernia oil development), and to Domestic Coinage (production and shipment of coins). The estimated 1997-98 expenditures for the programs we excluded represent less than one percent of the Department's total expenditures.

With the exception of the Tax Policy Branch, our audit covered the period from 1992 to 1997. In the case of the Tax Policy Branch, we followed up on a special 1993 audit of the changes that had been introduced in the organizational approach to effectiveness measurement in that Branch.

Criteria

The Department of Finance should have in place procedures and practices that enable it to:

- identify and communicate to Parliament the nature and extent of its policy and program-related responsibilities;
- inform Parliament clearly and consistently of the objectives of the policies, programs and operations for which it is accountable;
- measure program effectiveness to produce accurate, reliable and timely assessments of results achieved relative to objectives;
- report publicly on effectiveness;
- maintain a capacity for effectiveness measurement and reporting commensurate with its obligation to account to Parliament for results;
- organize the effectiveness measurement and reporting function to ensure objective, independent and timely analysis, and to sustain the function and its role; and
- integrate the planning of effectiveness measurement with its corporate planning processes.

Approach

The audit focussed on the measurement and reporting of effectiveness in those areas where the Department has direct policy and program-related responsibilities. We placed particular emphasis on public reporting because of the need for Parliament and the public to be informed clearly and regularly of the results of policies and programs, as well as of the nature and extent of the Department's accountability for them.

We sent a questionnaire to departmental branches with direct policy and program-related responsibilities. The questionnaire was designed to obtain information on those responsibilities, the planning and organization of effectiveness measurement, and effectiveness measurement undertaken and publicly reported. We conducted interviews with departmental officials to obtain further information and clarification. In addition, we examined the Department's submissions to Parliament in Part III of the Main Estimates for the period 1991–92 to 1997–98, government Budget Papers produced during the same period, departmental submissions to standing committees, and White Papers and legislative review reports.

Finally, we reviewed material on effectiveness measurement activities of other organizations and interviewed selected individuals from those organizations.

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Report of the Auditor General of Canada to the House of Commons – 1998

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Report of the
Auditor General
of Canada
to the House of Commons

Chapter 9
Reporting Government Financial Results:
The Importance of Complying with
Objective Accounting Standards

April 1998

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Auditor General
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The Importance of Complying with
Objective Accounting Standards



April 1998

This April 1998 Report comprises 9 chapters and a Foreword and Main Points. In order to better meet clients' needs, the Report is available in a variety of formats. If you wish to obtain another format or other material, the Table of Contents and the order form are found at the end of this chapter.

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Cat. No. FA1-1998/1-9E

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Chapter 9

Reporting Government Financial
Results: The Importance of
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Reporting Government Financial Results: The Importance of Complying with Objective Accounting Standards

Main Points

9.1 The 1980s and early nineties have seen major advances in financial reporting by sovereign governments, with Canada among the leaders. However, over the past two years the Government of Canada has begun departing from both objective accounting standards and its own stated accounting policies for certain transactions. Moreover, the 24 February 1998 Budget indicates that a similar departure will occur in 1998.

9.2 In 1996, transitional assistance for harmonizing PST with GST was included in the deficit even though provinces had not yet agreed to the harmonization by the end of the year. In 1997, funding of the Canada Foundation for Innovation was included in the deficit even though the Foundation did not exist by the end of the year. In 1998, the 24 February 1998 Budget indicates that funding of the Canada Millennium Scholarship Foundation will be included in financial results whether or not the Foundation exists by the end of the year.

9.3 As auditors of the government's financial statements, we are deeply concerned over this recent disregard by the government for objective accounting standards in reporting its financial results to Parliament and to Canadians. This is not merely a technical disagreement between an accountant and an auditor. Objective accounting standards are accepted and identifiable standards that are established by an arm's-length standard-setting body – the Canadian Institute of Chartered Accountants (CICA). Business firms cannot depart from objective accounting standards established by the CICA, to hide losses or to hide profits. Parliamentarians should expect no less from the government.

9.4 Meeting the significant challenges of the next decade will require, among other things, credible annual reports by the government on its overall financial health. In our view, departures from CICA standards and the government's own accounting policies must cease if credibility is to be restored to the reports that parliamentarians and others need.

9.5 Accordingly, we have recommended that the Government of Canada ensure that its accounting policies and practices conform with recommendations issued by the CICA's Public Sector Accounting and Auditing Board. Implementation of this recommendation will require continued diligence by the Public Accounts Committee of the House of Commons in reviewing the government's annual financial statements.

9.6 Although this chapter calls Parliament's attention to inappropriate accounting, there are related concerns that we have and will continue to report separately. They deal with accountability and parliamentary oversight for entities such as the Innovation Foundation and the Millennium Scholarship Foundation, and with whether or not such entities are, in substance, operating at arm's length from the government.

Introduction

9.7 Each year, the Government of Canada reports its financial results in the *Public Accounts of Canada*. Specifically, Section 1 of Public Accounts Volume I contains government-wide financial statements that this Office is required to audit and report on under section 6 of the *Auditor General Act*. The overall framework for reporting financial results, as described in this chapter, is depicted in Exhibit 9.1.

9.8 Our audit of the government's financial statements is carried out to express an opinion on whether the financial statements present information fairly. By performing our audit, we also enhance the credibility of reported financial results. If we find that the financial statements present information fairly, we say so by expressing what is called a "clean" opinion. However, if we have reservations about the financial statements, we give what is called a "qualified" opinion and explain our reservations. Unfortunately, our opinion on the government's 1997 financial statements was qualified for the reason described in paragraphs 9.26 to 9.31.

9.9 The purpose of this chapter is to call Parliament's attention to this recent problem with the financial statements that, if not corrected, could lead to an inappropriate picture of financial results and to qualified audit opinions for some years to come.

Observations and Recommendation

The Need for Objective Accounting Standards

9.10 In the public sector, we believe that there is a fundamental principle of accountability that requires governments to report financial information to legislatures in such a way that citizens can rely on the credibility of the information provided. This principle of credibility applies equally to private sector organizations when preparing financial statements for their readers.

9.11 For financial statements to be credible, readers need to have confidence that the statements follow some accepted and identifiable standards that are established by an arm's-length standard-setting body. Throughout this

A "clean" opinion from the auditors of a public sector or private sector organization adds credibility to the organization's reported financial results.

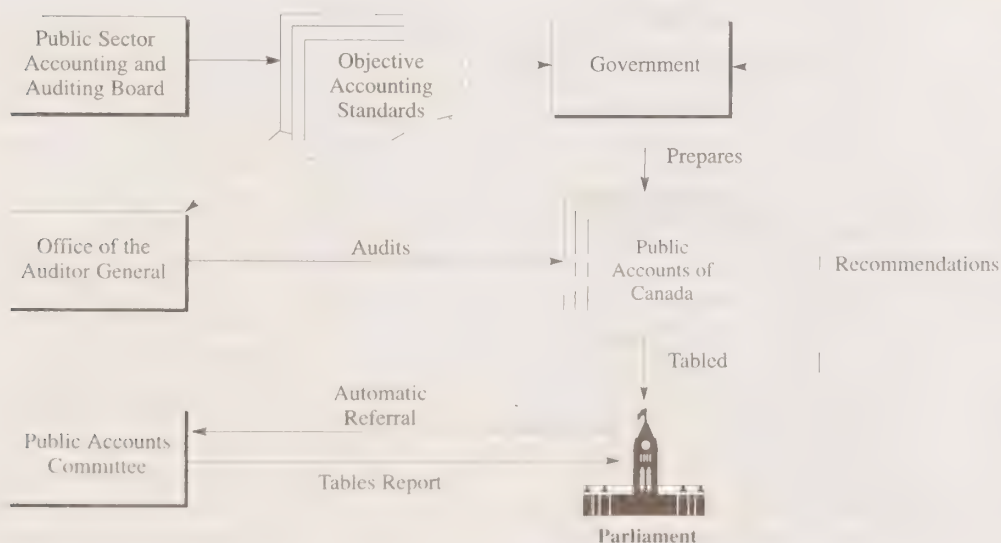


Exhibit 9.1

Framework for Reporting
Financial Results in the
Government of Canada

Business firms cannot depart from objective accounting standards; Canadians should expect no less from the government.

chapter, these are referred to as **objective accounting standards**. These standards cannot be subject to the individual preference of the financial statement preparer.

9.12 For example, a reader may wish to compare the financial statements of the federal government with those of a particular province, or to compare the financial statements of the same level of government over time, even though they may have been prepared by different governments drawn from different political parties. If individual governments of the day are free to choose whatever accounting policies and practices they wish, readers will have no confidence that the financial statements are consistent or comparable over time. And without such confidence, the credibility of all financial statements is compromised.

9.13 Financial statement preparers, indeed their auditors, may have their own ideas as to what accounting standards should say — they might prefer that a particular standard be different from what was promulgated and there may be good theoretical arguments for alternative viewpoints. But that is why, as described in Exhibit A.1 of Appendix A to this chapter, the processes for developing accounting standards provide ample opportunity to express individual points of view. Once the standards are promulgated, however, individual preferences must be submerged. And it follows that the standard-setting body must be at arm's length from the financial statement preparer — otherwise, the standards could be changed arbitrarily from year to year to suit the current preferences of management.

9.14 In the private sector, there are additional reasons for following objective accounting standards. Business firms who wish to sell debt or equity securities to the investing public must not be able to exaggerate financial results by devising and using accounting policies and

practices to hide losses. Similarly, firms who wish to minimize taxes or dividends must not be able to use policies and practices that hide profits.

9.15 Therefore, in order to guard against distortions of this type and to achieve credibility, the *Canada Business Corporations Act* requires all federally chartered public companies to prepare their financial statements in accordance with Generally Accepted Accounting Principles established by the Accounting Standards Board of the Canadian Institute of Chartered Accountants, or GAAP, as these principles are often referred to.

9.16 The consequences of not complying with GAAP could be very serious for a business firm. The reason is that the firm's auditors would be obliged to state in their opinion that GAAP had not been followed, which would send a clear signal to readers of the financial statements that the reported results were not credible. Further, Canadian securities regulatory authorities take a very dim view of qualified opinions. As a result, in the private sector one rarely sees financial statements departing from GAAP. Management cannot tolerate the negative consequences of a qualified opinion and will generally comply with GAAP to avoid it.

9.17 Parliamentarians and the Canadian public should expect no less from the federal government. And yet results frequently were inappropriately reported in the government's financial statements from the late 1970s through the end of the 1980s, as described in Appendix A to this chapter. This unfortunate situation occurred because there were no arm's-length standards of recommended accounting to which both the government and our Office could refer. It was therefore difficult for readers of the government's financial statements to have confidence that a consistent and fair presentation was being given to them. During debates in the House of Commons at the time, the government described the

situation as an “honest division of opinion” between two experts on technical accounting matters, and said that it could “list a number of accountants who will argue one side of this issue and a number who will argue the other side.”

9.18 Fortunately, since that time, objective accounting standards for Canadian governments have substantially been developed and published by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. Additional information on the activities and outputs of PSAAB is provided in Appendix A to this chapter. As also noted in the Appendix A, the government has substantially brought its accounting policies in line with PSAAB standards, as encouraged by the Public Accounts Committee.

Recent Departures from Objective Accounting Standards

9.19 Over the past two years, however, the federal government has begun departing from both objective accounting standards and its own stated accounting policies for certain transactions. These transactions are part of “transfer payments”, which comprise approximately 50 percent of the government’s expenditures. Some of the more significant transfer payments made by the government are for old age security benefits to individuals, and the Canada health and social transfer to provinces.

9.20 “Transfer payments”, often called grants and contributions, are payments in return for which the government receives no goods or services directly. Because transfer payments comprise such a significant portion of public sector expenditures, PSAAB has published recommendations on accounting for them.

9.21 The government’s stated accounting policies adhere to those recommendations. Note 1 to the

government’s annual financial statements states, “Transfer payments are recorded as expenditures when paid or when the recipient has fulfilled the terms of a contractual transfer agreement.”

9.22 Unfortunately, the government has not followed this policy when accounting for certain significant transfer payments in each of the past two years. Moreover, the 24 February 1998 Budget indicates that a similar departure will occur in 1998.

The 1996 problem: harmonizing GST and PST

9.23 In 1994, the government began a series of discussions with provinces to streamline and simplify the operation of Canada’s value-added tax system. The proposal was to harmonize the federal goods and services tax (GST) with provincial sales taxes (PST). In late March of 1996, the government made a formal offer to the provinces of Newfoundland and Labrador, Nova Scotia and New Brunswick to provide transitional assistance totalling \$961 million, payable when they entered into a detailed agreement to harmonize their PST with the GST. In early April of 1996, the three provinces agreed to continue negotiations, and memoranda of understanding (MOUs) were signed. The MOUs called for agreements to be negotiated and in place within six months, for enabling legislation to be enacted by Parliament and each provincial legislature and for harmonization to commence on 1 April 1997. The amount of transitional assistance was based on a formula, and officials advised that it was not subject to revision. As disclosed in Note 4(v) to the government’s 1996 financial statements, the transitional assistance of \$961 million was recorded as a liability at 31 March 1996, and as an expenditure and resultant increase in the deficit for that fiscal year.

9.24 At the time of finalizing the 1996 financial statements and our opinion on them, negotiations were still continuing

Objective accounting standards exist for governments and, encouraged by the Public Accounts Committee, the government has substantially brought its accounting policies in line with them.

Recently, the government has begun departing from its own accounting policies for transfer payments.

In 1996, the government included \$961 million in the deficit for harmonizing GST and PST, departing from its own accounting policies.

between the three provinces and the government. Matters outlined in the MOUs were still under discussion, such as the definition of the common tax base, mechanisms to tax interprovincial transactions, and the number of provincial employees who would be employed by the government to administer the harmonized taxes. In addition, although federal legislation to authorize the transitional assistance of \$961 million was tabled in Parliament on 23 April 1996 and received royal assent on 20 June 1996, enabling legislation for the three provinces had not yet been introduced in their respective legislatures.

9.25 Therefore, at 31 March 1996 the recipient provinces had not fulfilled the terms of a contractual transfer agreement. The agreements to harmonize were not signed and in place until more than six months after the close of the 1996 year. And yet the government recorded the transaction as if the agreements had been signed and in place at 31 March 1996. This represents a significant departure from the government's own accounting policies.

The 1997 problem: the Canada Foundation for Innovation

9.26 In the 18 February 1997 Budget, the government announced its intention to establish the Canada Foundation for Innovation. The Foundation would be operated independently of government through a board of directors, a majority of whom would be drawn from the private sector and research and academic communities. The Foundation's purpose is to combine government and private sector funding to enhance education and research infrastructure at post-secondary institutions and research hospitals. The government stated that the Foundation would be funded by an up-front investment of \$800 million. This transaction was recorded in the government's 1997 financial statements as

if it were a liability, and was charged to the deficit of that year.

9.27 Legislation to implement certain provisions of the 1997 Budget was not given first reading in the House of Commons until 9 April 1997, and the *Budget Implementation Act, 1997* did not receive royal assent until 25 April 1997. Part I of the Act established the Foundation and Part XI provided parliamentary authority for the payment of \$800 million plus interest to the Foundation.

9.28 A funding agreement between the Foundation and the government was not signed until 2 July 1997, and the \$800 million (plus interest of \$964,000) was not paid to the Foundation until that date. Among other things, the funding agreement sets forth the terms and conditions under which the Foundation shall both administer and invest those funds and determine to whom it shall disburse those funds. At the time of writing this chapter, no disbursements had yet been made to eligible recipients.

9.29 One key element of the government's own accounting policies is that for a transfer payment to be included in financial results, a "recipient" must exist. In this case, at 31 March 1997, there was no recipient to which the Government of Canada owed \$800 million. The recipient, that is the Foundation, was not created until 25 April 1997 when the *Budget Implementation Act, 1997* received royal assent.

9.30 A second key element of the government's own accounting policies is that for a transfer payment to be included in financial results, the recipient must have fulfilled the terms of a contractual transfer agreement. In this case, the funding agreement setting out these terms was not signed until July 1997.

9.31 Nonetheless, the government recorded the transaction as if the recipient had existed at 31 March 1997 and the funding agreement had been in place at

In 1997, the government included \$800 million in the deficit for the Canada Foundation for Innovation, departing again from its own accounting policies.

that time. This was the second year in a row that the government departed from its own accounting policies.

The 1998 problem: the Canada Millennium Scholarship Foundation

9.32 In the 24 February 1998 Budget, the government announced its intention to create the Canada Millennium Scholarship Foundation. The Foundation will be managed by a board of directors, at arm's length from the government. The Foundation's purpose is to provide scholarships annually to Canadians from low- and middle-income families for post-secondary education.

9.33 The government stated that it will provide an initial endowment of \$2.5 billion to the Foundation. An endowment, similar to the funding of the Canada Foundation for Innovation in 1997, is a transfer payment (defined in paragraph 9.20). This transaction will be recorded in the government's 1998 financial statements as if it were a liability, and will be included in the financial results of that year.

9.34 The Budget documents said that legislation to establish the Foundation would be introduced in the House of Commons shortly after the Budget date. At the time of writing this chapter, officials had advised us that it was highly unlikely that this legislation would be passed by 31 March 1998. After the legislation has passed, the Foundation's board members will be appointed and a funding agreement signed that sets forth the terms of investing the endowment and disbursing it to eligible recipients. Officials advise us that this will not occur until well after 31 March 1998. Scholarships will not be awarded to eligible recipients until the year 2000.

9.35 Neither of the key elements in the government's own accounting policies — the legal existence of a recipient or the fulfillment of the terms of a contractual transfer agreement — will have been met

by 31 March 1998. Nonetheless, indications are that the government intends to record this \$2.5 billion transaction as if they had. This will therefore represent the third year in a row that the government has departed from its own accounting policies for transfer payments.

The government's rationale for these departures

9.36 The government believes that it should take financial accountability — reflected in its financial results — for its decisions to incur expenditures for transfer payments in the year those decisions are taken. The government also believes that transparency is achieved by providing full disclosure of such transactions in the Budget and the financial statements.

9.37 While these views may have some intuitive appeal, they do not conform with objective accounting standards. Under such standards, the announcement of an intention to make payment is more in the nature of a "commitment". Commitments are reported in notes to financial statements, but are not reflected in financial results. This prevents management from influencing reported results by simply announcing a decision toward the end of a particular year to spend money in some future year. Annually, the government reports tens of billions of dollars in commitments in notes to its financial statements but does not reflect them in its financial results.

9.38 In the 24 February 1998 Budget, the government states, "Non-recurring liabilities will be recognized in the year in which the decision to incur the expenditure is made, provided the enabling legislation or authorization for payment receives parliamentary approval before the financial statements for that year are closed." If the government changes its accounting policies for transfer payments in this manner, those policies will no longer conform with the

The 24 February 1998 Budget indicates that the government will include \$2.5 billion in the 1998 financial results for the Canada Millennium Scholarship Foundation, departing from its own accounting policies for the third year in a row.

The government states that these non-recurring events create liabilities that should be reflected in financial results if parliamentary approval is granted before the financial statements are closed.

We believe that this is contrary to objective accounting standards and could lead to undesirable management influence on reported financial results.

recommendations of PSAAB. In our view, non-conformance with PSAAB is as serious an issue as departures from the government's own accounting policies.

9.39 The Government of Canada should ensure that its accounting policies and practices conform with recommendations issued by the Canadian Institute of Chartered Accountants' Public Sector Accounting and Auditing Board.

Treasury Board Secretariat's response: It is the government's view that its accounting policies and practices generally conform in substance to recommendations of the Canadian Institute of Chartered Accountants (CICA). The government believes its decisions and public announcements to provide funding to arm's-length organizations such as the Canada Foundation for Innovation establish liabilities that should be recorded in the years in which the decisions are made. These liabilities meet the definitions of both equitable and constructive obligations as defined in the CICA Handbook and reflect substance over form. In addition, the government believes that transparency and accountability are best served by recording these liabilities in the year in which the government made its decision to incur them.

Related Concerns

9.40 We have related concerns regarding entities such as the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation. One of these concerns, which revolves around issues of accountability and parliamentary oversight, is elaborated upon in Chapter 36 (paragraphs 36.48 to 36.54) of

our December 1997 Report. It relates to the fact that the Canada Foundation for Innovation is not obliged to report on the results it achieves with \$801 million of public money and that Parliament may consequently have difficulty obtaining the information it needs on this kind of expenditure.

9.41 A second concern relates to what we would call the essential nature or substance of these types of entities. We will be examining this matter further and will report separately if significant findings emerge. Questions that we will address in this study will include whether, in substance or in fact, such entities operate at arm's length from the government.

Conclusion

9.42 The purpose of this chapter has been to call Parliament's attention to a recent departure from objective accounting standards and the government's own accounting policies for recording transfer payments. By not following objective accounting standards — accepted and identifiable standards that are established by an arm's-length standard-setting body — the government puts the credibility of its financial statements into question. We believe that implementing our recommendation would resolve this recent problem and would restore the credibility of government-reported financial results.

9.43 Implementing this recommendation will require continued diligence by the Public Accounts Committee in reviewing the government's annual financial statements to help ensure that objective accounting standards are followed.



About the Study

Objective

Our objective was to call Parliament's attention to a recent problem with the financial statements of the Government of Canada that, if not corrected, could lead to an inappropriate picture of financial results and to qualified audit opinions for some years to come.

Scope and Approach

This study is based on the research of existing literature as follows :

- Section 1, Volume I of the 1996 and 1997 Public Accounts of Canada and certain sections of the Public Accounts of Canada from 1979 to 1994
- 24 February 1998 Budget
- Recommendations of the Canadian Institute of Chartered Accountants Public Sector Accounting and Auditing Board
- Recommendations of the Public Accounts Committee of the House of Commons
- Recent activity in government-wide financial reporting across the world

Study Team

Assistant Auditor General: Ronald C. Thompson

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Jeff Greenberg

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Margo Longwell

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Appendix A

Additional Background Information

Introduction

This appendix provides additional background information on the Government of Canada's annual financial statements.

Throughout the 1980s, the credibility of the government's annual financial statements improved considerably. By 1990, the Auditor General was finally able to provide an audit opinion without reservation — a "clean opinion". Two critical factors helped bring this about. First, the Public Accounts Committee (PAC) of the House of Commons reviewed the financial statements frequently and encouraged the government to improve them. Second, authoritative standards of recommended accounting and reporting practice were developed to which both the Comptroller General and the Auditor General could refer in assessing fairness.

The 1990s brought further improvement. A concise annual financial report was published to help make reported results more understandable. Also, indicators of financial condition were developed to help make reported information more useful. Internationally, the government of New Zealand began publishing audited government-wide financial statements and Australia and the United States are planning to follow suit. In addition, two international bodies — one auditing and the other accounting — began publishing guidance on accounting and financial reporting for governments around the world.

The Evolution of the Government of Canada's Financial Statements

Virtually since Confederation, the Government of Canada has prepared and published an annual report on financial matters, entitled *The Public Accounts*. Until quite recently, the Public Accounts were primarily concerned with reporting: the use made by the government of authorities granted by Parliament to spend, borrow and raise revenues; analyses of revenues, expenditures, assets and liabilities; listings of individual transactions of interest to parliamentarians; and related commentary. This is important accountability information in the public sector and it continues to be included in the Public Accounts to the present day.

Prior to the mid-1970s, statements of assets and liabilities and of revenues and expenditures were presented in separate sections of the Public Accounts, following considerable detailed analysis and commentary. Each of these two statements contained a "certificate" by the Auditor General reporting that they exhibited a correct view, subject to comments in his annual report to the House of Commons. There were two problems with this type of reporting. First, a summary financial overview of the government was not presented in one place and the information that was reported was buried within massive amounts of detail. Second, in order to determine whether the Auditor General was satisfied with the statements, readers had to consult a separate report — the Auditor General's annual report — and be able to assess whether comments there affected the fairness of the statements.

Throughout the remainder of the 1970s, significant changes were made to the presentation and audit of the government's summary numbers. The financial statements were moved to the front of the Public Accounts and presented together in one section. Footnotes were included in this section to explain the basis of accounting used in preparing the statements and to provide other explanatory information. The Auditor General's annual opinion on the fairness of the statements was also included in this section.

By 1980, the government's financial statements were more visible and the Auditor General's opinion was more understandable. However, the statements continued to be prepared on an accounting basis that mirrored legislative authorities to spend, borrow and raise revenues. This accounting basis was not necessarily appropriate for reporting the government's overall financial position and operating results. For example, it resulted in over \$4 billion of liabilities being excluded from the accounts and over \$3 billion of money the government owed to itself being shown as assets. Clearly, there was a need for a more appropriate basis of accounting for the annual financial statements.

In the early 1980s — with support and encouragement from the PAC, the government and our Office — the Canadian Institute of Chartered Accountants (CICA) formed a Public Sector Accounting and Auditing Board (PSAAB) to develop accounting and financial reporting standards that could be recommended to Canadian governments. Throughout the 1980s and well into the 1990s, the PAC held a number of hearings to consider issues raised by our Office on the fairness of the financial statements; PSAAB developed and recommended a number of important standards; and the government implemented major reforms to the form and content of its financial statements.

In addition, commencing in 1994, the government began publishing condensed financial statements in a concise user-friendly annual financial report not unlike reports published by corporations in the business world. This separate document is published before the Public Accounts, and includes our audit opinion on the condensed financial statements included therein. And just last year, the CICA published a research study that called on Canadian governments to report their overall financial condition through a set of 10 “simple indicators”. The government’s concise report and the CICA’s 10 indicators represent major contributions to governments within Canada and abroad who are trying to make overall financial reporting more understandable and more useful to legislators and citizens.

The following two sections of this appendix elaborate on the work of PSAAB to develop objective standards of recommended accounting and reporting practice, and on the key role played within Canada by the PAC.

The Development of Objective Standards of Recommended Accounting and Reporting Practice in Canada

In 1978, the Auditor General began giving a concise audit opinion on the federal government’s annual financial statements as required by section 6 of his new Act. What made this task particularly difficult, for both auditor and preparer, was that there were no standards of recommended accounting and reporting practice to which each could refer. As a consequence, the whole exercise was quite subjective and not as useful as it should have been for members of Parliament and Canadians generally.

In these early years, the preparer (the Office of the Comptroller General) and the auditor (the Office of the Auditor General) simply could not agree on how the summary numbers should be shown to present fairly the government’s overall financial position and operating results. When it came time to report on the financial statements, the Auditor General felt obliged to issue audit opinions with several significant reservations. When the Public Accounts were tabled in the House of Commons with these very negative opinions, parliamentarians became quite vocal during Question Period. One year, after listening to heated discussion, the then-Minister of Finance rose and explained that in his view, the issue was simply an “honest division of opinion” between two experts on technical accounting matters. The Minister went on to say, “We can list a number of accountants who will argue one side of this issue and a number who will argue the other side.” And at that, the issue died. The Auditor General believed that the summary numbers were not presented fairly, but he was unable to say so persuasively because he had no credible standards to refer to. Parliamentarians and other users of the financial statements were put in the unfair position of having to determine who was right, the preparer or the auditor.

In 1981, the CICA created PSAAB to provide these standards, after carrying out an extensive, in-depth study of the accounting and financial reporting practices of Canadian federal and provincial governments. That study showed that individual governments accounted for the same transactions in very different ways, making it virtually impossible to make any meaningful government-to-government comparisons. In addition, the information presented in government financial statements was fragmented and incomplete — to the point of misleading users. Major liabilities went unrecorded, financial assets were overvalued and debts were accumulated in subsidiary organizations that were not included in governments’ financial statements.

The objective of PSAAB is to recommend standards to improve and harmonize financial reporting, accounting and auditing in the “public sector”. As stated in the introduction to PSAAB’s recommendations, “public sector” refers to federal, provincial, territorial and local governments, government organizations jointly owned or controlled by two or more governments, and school boards. PSAAB issues such recommendations and guidance to serve the public interest by strengthening accountability in the public sector through developing, recommending and gaining acceptance of accounting, financial reporting and auditing standards of good practice.

Reporting Government Financial Results: The Importance of Complying with Objective Accounting Standards

These standards are developed by the people who will be governed or affected by them. PSAAB follows a rigorous “due process” that gives those affected by the pronouncements an opportunity to express their views while issues are being considered and recommendations developed. Members of PSAAB and its associates include deputy and assistant deputy ministers, comptrollers, auditors general and executives of government organizations. Two thirds of the members of PSAAB and its task forces who develop the standards are selected from government, made up of those responsible both for financial reporting and for auditing.

Over the years, PSAAB has issued a number of general and specific accounting recommendations that are gaining wide acceptance within Canada, both federally and provincially. A summary of outputs is presented in Exhibit A.1. The result has been much more credible accounting and financial reporting by Canadian governments, and much more support for those who maintain the accounts and those who audit them. This has been particularly important in the past decade as the measurement and reporting of government deficits or surpluses and accumulated debts has taken on considerable significance everywhere.

The Key Role Played in Canada by the Public Accounts Committee of the House of Commons

Since 1979, the PAC has met numerous times to consider the annual financial statements of the Government of Canada and the Auditor General’s related Opinion and Observations. To date, the PAC has issued five reports to the House of Commons on matters relating to the financial statements. A summary of the Committee’s recommendations is presented in Exhibit A.2. Virtually all of these recommendations have now been acted on by the government. This interest and support by the PAC has been a major factor in bringing about strengthened accounting and financial reporting over the years. Significant actions by the government in response to PAC Reports are shown in Exhibit A.3.

Government-wide Financial Reporting across the World

Throughout the 1980s, Canada was virtually alone among industrialized nations in preparing and publishing audited government-wide financial statements at the federal level. However, in 1993, the Government of New Zealand began publishing audited government-wide financial statements. The federal governments of Australia and the United States are planning to follow suit. There are a number of similarities among these three initiatives to implement government-wide financial reporting. For example, in each case:

- the financial statements are or will be prepared in accordance with generally accepted accounting and financial reporting standards, developed objectively by an appropriate standard-setting body;
- the accounting and reporting standards are based on the “accrual accounting” concept in order to help ensure that assets and liabilities are reported completely and valued realistically;
- the exercise of preparing summary financial statements and submitting them for audit is seen as imposing a discipline on individual departments and agencies to strengthen the financial information they use to manage; and
- the financial statements are seen as providing an understandable annual scorecard of where the government stands financially, for use in making strategic decisions and setting overall priorities and policies.

The experience of the Government of Canada in preparing and publishing audited annual financial statements is very similar. We also believe that accountability information about government is needed at two levels: government-wide to determine whether the sum of all program costs is affordable; and program by program to determine which programs are working well and which are not.

Internationally, there has been considerable activity in recent years to develop guidance for governments on financial reporting and accounting. Two organizations — one auditing and the other accounting — are playing a lead role here. Both recognize the importance of governments adopting “accrual accounting” — the type of accounting and financial reporting that PSAAB recommends and that Canadian governments are implementing.

Exhibit A.1

Accounting Guidance from the
Public Sector Accounting and
Auditing Board

Concepts & Principles

Objectives of Financial Statements — This Section identifies and describes objectives of a government's financial statements that are generally acceptable to the users and preparers of the statements. These objectives provide the basis for determining standards of financial statement reporting and accounting principles that are consistent with one another and appropriate for government, with the goal of improving government financial statements and enhancing their comparability.

General Standards of Financial Statement Presentation — This Section recommends general reporting principles and standards for the disclosure of information in government financial statements, based on the objectives of government financial statements.

Financial Reporting Entity — This Section defines the scope of the reporting entity in terms of the organizations whose financial affairs and resources should be accounted for in a government's financial statements and recommends how to account for the financial affairs of those organizations in the government's financial statements.

Specific items — Financial Reporting

Disclosure of Accounting Policies — This Section deals with the disclosure of accounting policies adopted by a government in the preparation and presentation of its financial statements. Accounting policies are the specific accounting principles used by a reporting entity and the methods for applying those principles.

Accounting Changes — This Section deals with the accounting and reporting in government financial statements of (a) a change in an accounting policy; (b) a change in an accounting estimate; and (c) a correction of an error relating to prior period financial statements.

Subsequent Events — This Section deals with the accounting and reporting in government financial statements of events occurring after the financial statement date that may indicate a need to adjust items or to make specific disclosures in those statements.

Temporary Investments — This Section deals with the accounting and reporting of all investments that are transitional or current in nature in government financial statements.

Specific items — Financial Statement items

Loans Receivable — This Section recommends how to account for and report loans receivable in government financial statements, giving particular attention to special characteristics that distinguish them from commercial loans made in the private sector.

Restricted Assets and Revenues — This Section recommends how to account for and report restricted assets and revenues in the financial statements of governments, which are not available to meet the government's general obligations and finance its other activities.

Tangible Capital Assets — This Section recommends how to account for and report tangible capital assets in government financial statements, which include such diverse items as roads, buildings, vehicles, equipment, land, water systems, aircraft, computer hardware and software, dams, canals and bridges.

Long-term Debt — This Section deals with the presentation and disclosure of long-term debt in government financial statements.

Employee Pension Obligations — This Section recommends how to account for and report employee pension obligations in government financial statements.

Loan Guarantees — This Section recommends how to account for and report government loan guarantees in government financial statements. For the purposes of this Section, a loan guarantee is a promise to pay all or a part of the principal and/or interest on a debt obligation in the event of default by the borrower.

Government Transfers — This Section recommends how to account for and report government transfers in the financial statements of governments. For the purposes of this Section, government transfers are transfers of money from a government to an individual, an organization or another government for which the government making the transfer does not (a) receive any goods or services directly in return, as would occur in a purchase/sale transaction; (b) expect to be repaid in the future, as would be expected in a loan; or (c) expect a financial return, as would be expected in an investment.

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Exhibit A.2

**Public Accounts Committee Recommendations
Concerning the Financial Statements of the
Government of Canada, 1979 through 1997**

(Words in italics added)

First Report, 21 February 1979 – Respecting the 1978 Financial Statements

5. Your Committee again recommends that legislative action be taken as soon as possible to delete from the accounts of Canada the assets and liabilities identified in Notes 5 and 7 to the audited financial statements and to prevent similar balances from recurring in future years.
7. Your Committee recommends that the accounting entity of the Government of Canada should include all Crown corporations substantially dependent on public funds or carrying on government operations.
9. Your Committee recommends that the Office of the Comptroller General review each year loans to and equity investments in Crown corporations with a view to recommending that adequate provision be made through budgetary appropriations where such corporations lack sufficient revenues to repay the investment of Canada.
11. Your Committee recommends that:
 - (a) The terms of loans to developing countries and loans to and subscriptions in international development associations be adequately disclosed in the audited financial statements of the Government of Canada; and
 - (b) The Office of the Comptroller General expedite a study to establish an appropriate basis for valuing such loans and subscriptions and report back to the Committee as soon as possible.

Thirteenth Report, 22 March 1982 – Respecting the 1981 Financial Statements

15. Your Committee recommends that:
 - (a) the Comptroller General report back to your Committee on the progress of the studies regarding accounting principles for governments by October 31, 1982 and annually thereafter, until these principles have been established and are in use in the Government of Canada;
 - (b) the Government consider the advisability of amending the Financial Administration Act to vest the responsibility and authority for the improvement of government accounting in the President of the Treasury Board; and
 - (c) the Government consider the advisability of amending the SRBA Act in order to record the actuarial deficiency arising from this Act as a liability in the accounts of Canada. *(This Supplementary Retirement Benefits Act provides for indexing of employee pensions, which was not included in reported liabilities at the time of this hearing)*

Eighth Report, 30 June 1987 – Respecting the 1986 Financial Statements

7. Your Committee recommends that the Government invite the Canadian Institute of Chartered Accountants (CICA) to examine those accounting policies of the Government that cause concern to the Auditor General in his audit of the Government's financial statements or do not fully conform to CICA standards and to recommend changes so that a "clean" Opinion can be obtained. *(Subsequently, the CICA explained that its role was to set standards but not arbitrate)*
15. Your Committee, therefore, recommends that the Government obtain an independent professional opinion from the Canadian Institute of Chartered Accountants on the reporting of sovereign loans where the risk of loss to the Government of Canada is significant. *(See above)*
18. Your Committee recommends that the Office of the Comptroller General provide it with a progress report on the consolidation of Crown corporations in the financial statements of the Government by September 30, 1988.

21. Your Committee recommends that the Office of the Comptroller General provide it with a progress report with respect to the Federal Government Reporting Study recommendations by September 30, 1987. (*The Federal Government Reporting Study was conducted jointly by our Office and the US General Accounting Office; its main recommendation was that the government prepare and publish a concise user-friendly annual financial report*)

Second Report, 10 October 1989 – Respecting the 1988 Financial Statements

14. Your Committee recommends that:

- (a) the Comptroller General and the Deputy Minister of Finance resolve the issues raised by the reservations of the Auditor General in his Opinion on the Government's Audited Financial Statements;
- (b) the Minister of Finance introduce accounting policy changes in his 1990 Budget for implementation in the 1989–90 Public Accounts that would permit the Auditor General to remove the reservations in his Opinion on the Government's Audited Financial Statements; and
- (c) the Minister of Finance and the President of the Treasury Board report jointly in writing to your Committee on recommendations (a) and (b) above by March 31, 1990.

Fifth Report, 13 March 1992 – Respecting the 1991 Financial Statements

- A. The Committee recommends: that more accurate estimations of income tax revenue collected on behalf of provinces and territories be used when issuing the next Public Accounts of Canada for 1991–92.
- B. The Committee therefore recommends:
 - (1) that the government correctly account for the actuarial liability associated with wage restraints, by not treating the repercussions of the Public Sector Compensation Act as a curtailment of the federal employees' pension plan. Consequently, the government must amortize this actuarial adjustment over a thirteen-year period, as is generally accepted in sound accounting practice;
 - (2) that, as soon as possible, the government publish corrected financial statements for 1990–91 that perfectly account for the actuarial impact of wage restraints and correctly reflect the repercussions of wage controls spread over two years rather than three. (*The government declined to publish corrected statements*)
- C. The Public Accounts Committee therefore recommends:
 - (1) that the adjustment to the value of the federal government's investment in Petro-Canada be charged off to the 1990–91 fiscal year, the year during which it was identified;
 - (2) that, as soon as possible, the government publish corrected financial statements that faithfully reflect the value of the federal government's investment in Petro-Canada (*see above*);
 - (3) that the government adopt accounting practices that would respect PSAAC (*now called PSAAB*) Accounting Statement 4 (Defining the Government Reporting Entity, November 1988) on accounting for investments in Crown corporations. The government would thus account for Crown corporations' net losses (or gains) as part of its own losses, at the time they occurred.

Reporting Government Financial Results: The Importance of Complying with Objective Accounting Standards

Exhibit A.3

Improvements in the Audited Financial Statements of the Government of Canada 1979 through 1994

1979

Significant "internal accounts" — amounts owed by the government to itself — were removed from the government's statement of assets and liabilities.

1980

Loans to and investments in financially dependent Crown corporations were written down, and additional amounts payable at year-end were recorded in the accounts.

The terms of loans to developing countries and subscriptions to international development associations were disclosed in notes to the statements.

1984

Amounts payable under certain statutory (continuing) authorities were recorded in the accounts, and provision was made in respect of amounts owing for employee vacation and termination benefits.

A liability was included in the statement of assets and liabilities for the government's share of Crown corporation borrowing, and a partial write-down was made for subscriptions to international development associations.

1985

The transactions of the Canadian Ownership Account were included on the statement of revenue and expenditure, instead of being excluded from the deficit as in prior years by being shown on the statement of assets and liabilities.

1986

The separate financial transactions of certain significant departmental activities such as Employment Insurance were consolidated with the government's financial statements.

Loans to developing countries and subscriptions to international development associations were written down in full.

1990

The separate financial statements of financially dependent Crown corporations were consolidated with the government's financial statements.

Loans to other sovereign governments were written down in value.

The liability for employee pensions was recorded fully in the accounts.

The result of all of this was the first "clean" opinion on the annual financial statements.

1993

An allowance for an estimated amount owing under loan guarantees was recorded in the accounts.

A change was made to the way the accounts recognized the effect of wage restraint on the employee pension liability.

1994

A concise, user-friendly annual financial report was published for the first time, containing condensed (simplified) financial statements.

An allowance for loans expected to be recovered from future appropriations was recorded in the accounts.

Appendix B

Recent Correspondence with Government Officials

This chapter calls on the government to follow objective accounting standards in reporting financial results to Parliament and to Canadians. The chapter explains that a significant departure from objective accounting standards has occurred in each of the past two years and could occur again this year. On 12 March 1998, government officials wrote to the Auditor General stating that the government had not departed from these standards and offering arguments to support their view. The Auditor General replied to that letter on 18 March 1998. Both letters were copied to the Chairman of the Public Accounts Committee of the House of Commons and are reproduced on the following pages. In his reply, the Auditor General undertook to provide more detailed comments separately. This has now been done and detailed comments are presented at the end of this appendix. The Auditor General also encouraged continued discussions to resolve the disagreement. Although additional discussions were held with government officials, a resolution was not found.

Reporting Government Financial Results:
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Treasury Board of Canada
Secretariat

Conseil du Trésor du Canada
Secrétariat

Ottawa, Canada
K1A 0R5

12 March 1998

Mr. L. Denis Desautels, FCA
Auditor General of Canada
240 Sparks Street
Ottawa, Ontario
K1A 0G6

Dear Mr. Desautels:

Last year, with respect to the accounting treatment accorded the transfer payment to the Canada Foundation for Innovation, you included in your opinion on the financial statements of the Government of Canada a reservation that the government was not adhering to its stated accounting policies as described in the notes to those financial statements. The subsequent discussion of this issue at the December 9, 1997, meeting of the Standing Committee on Public Accounts, the announcement by the Minister of Finance in his recent budget of a similar transaction related to the Canada Millennium Scholarship Foundation, and the matters raised in the proposed chapter 9 of your April report make it clear that the government should take action to end this controversy. Therefore, the President of the Treasury Board and the Minister of Finance have agreed to clarify the government's accounting policies to ensure that transactions of the type at issue are accounted for in the fiscal year in which the decision is taken to incur the expenditure.

In its 1997-98 financial statements, the government will revise the note on significant accounting policies to indicate that a public commitment to provide funding to an arm's-length entity represents the establishment of a liability to disburse government funds, and, that in the interests of transparency and accountability, such liabilities are recorded in the financial statements in the year in which the decision to incur such expenditures is made, provided proper parliamentary authority is in place before the financial statements for that year are closed.

Specifically, the government proposes to state in its significant accounting policies (4th paragraph under "Basis of accounting"):

Transfer payments are recorded as expenditures when paid, when the recipient has fulfilled the terms of a contractual transfer agreement, or in the case of non-recurring transactions which do not form part of an existing program, when the government publicly announces a decision to make a transfer, provided enabling legislation or authorization for payment receives parliamentary approval.

In addition, whenever such a non-recurring transaction is recorded, the government will include a separate note to the financial statements describing the transaction and its amount.

The government is of the view that support for recording these transactions can be found in professional literature. For instance, the Handbook of the Canadian Institute of Chartered Accountants (CICA) defines a liability as an obligation arising from past transactions or events, the settlement of which may result in the transfer of assets in the future. The Handbook goes on to note that liabilities do not have to be legally enforceable; they can be based on equitable or constructive obligations. A constructive obligation is a duty based on ethical or moral considerations. A constructive obligation is one that can be inferred from the facts in a particular situation as opposed to a contractually based obligation. It is the government's opinion that the "event" of making a decision to provide funding to a arm's length foundation establishes both a "constructive" and an "equitable" obligation, provided Parliament subsequently provides the necessary authority.

Furthermore, recent changes to CICA Handbook Section 3465, Income Taxes, indicate that it is appropriate to recognize liabilities under the concept of "substantive enactment", i.e. recognizing liabilities if there is persuasive evidence that the government is able and committed to enacting the proposed legislation in the foreseeable future.

A second argument supporting the government's approach is the principle of "substance over form". The CICA Handbook states "transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form." It is the government's view that reporting the planned transfers to entities such as the foundations reflects the substance of government decision-making and economic reality. To not recognize these obligations on the basis that the "legal work" is not yet in place would be misleading. This same philosophy can be found in the recommendations of the CICA's Emerging Issues Committee to the effect that liabilities related to restructuring costs be recognized when the authoritative decision is made to incur such costs.

This concept also applies to government transfers. CICA Handbook Section PS3410, paragraph .07, states "... Judgement will be required to account for transfers in a manner that best reflects the substance of the underlying events rather than the form or funding pattern."

We would also draw to your attention that the accounting standards require us to consider events occurring between the date of the financial statements and the date of their completion when such events provide sufficient, additional evidence relating to conditions that existed at the date of the financial statements.

We are disappointed that our discussions to date have not been able to resolve this difference of opinion. Your position confuses a legitimate difference of opinion about the appropriate application of accounting standards, thereby, affecting the credibility of the financial statement of the government.

We also wish to register our profound astonishment that this issue has now been reported in the press (Ottawa Citizen, Wed. March 11/98) as a result of an interview you gave. It appears to us that you have taken the unprecedented step of releasing the contents of your report which you fully intend to release in April under the guise of "considering the unusual step of writing a report". We believe this to be inappropriate under the circumstance given your reporting role to Parliament.

Reporting Government Financial Results:
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We believe that the proposed changes will make it clear to users of the government's financial statements which transactions are included in financial activity for the year and will identify clearly the basis for determining the annual financial results of the government. It is our view that the changes will also lead to better financial reporting to Parliament and the public.

Yours sincerely,

C. Scott Clark
Deputy Minister
Department of Finance

V. Peter Harder
Secretary of Treasury Board/
Comptroller General

c.c.: Mr. John Williams,
Chairman, Standing Committee on Public Accounts

240 Sparks Street
Ottawa, Ontario
K1A 0G6

18 March 1998

Mr. C. Scott Clark
Deputy Minister of Finance
Mr. V. Peter Harder
Secretary of Treasury Board & Comptroller General
Ottawa, Ontario
K1A 0R5

Dear Mr. Clark and Mr. Harder:

Thank you for your letter of 12 March wherein you comment on our proposed Chapter 9 that we are considering including in next month's Report to Parliament. I am writing to set out my thoughts on a number of items that you raise in your letter.

You register astonishment that certain of the issues raised in the chapter have been reported in the Ottawa Citizen on 11 March as a result of an interview that I gave. In this respect, I would point out that my deep concern with the government's recent departures from objective accounting standards has been clearly and forcefully reported to Parliament in my Observations on the government's 1996 and 1997 financial statements and discussed in some detail with the Public Accounts Committee during two related public hearings. I have also raised additional concerns with the Innovation Foundation in chapter 36 of last December's Report to Parliament (paragraphs 36.48 to 36.54). With this background in mind, I believe that it was quite appropriate for the media to ask for my views on the accounting proposed for the new Millennium Foundation in last month's Budget and for me to respond in the manner that I did.

In your 12 March letter, you advise that the note on significant accounting policies in the government's 1997-98 financial statements will be revised "... for non-recurring transactions ..." to sweep in as liabilities "... public commitment(s) to provide funding to an arm's-length entity ..." providing "... proper parliamentary authority is in place before the financial statements for that year are closed." You advance a number of arguments to support this change in accounting drawn from the Handbook of the Canadian Institute of Chartered Accountants (CICA). We have studied these arguments and we do not believe that they support the accounting that you propose in your letter. For the most part, your arguments are based on Sections of the CICA Handbook that are unrelated to the central issue of when the Government should recognize transfer payments as liabilities and expenditures. For example, two of the Sections that you refer to deal with (1) how business firms measure income tax liabilities that are already recognized, and (2) when business firms recognize costs of exiting existing activities. In our view, Handbook Section PS3410 provides clear guidance to governments on when transfer payments should be recognized as liabilities and expenditures, and the accounting change that you propose does not conform with this Section. We will communicate more detailed comments to you separately.

Last summer, in a meeting with Mr. Harder and his senior officials, we agreed to work together behind the scenes in order to clarify our interpretation of CICA recommendations as they relate to the accounting for and reporting of transfer payments. The idea was to head off continuing public disagreement between preparer and auditor with respect to transactions such as the GST/PST harmonization costs and funding of the Innovation Foundation. In early February

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of this year, Mr. Harder's officials provided my staff with a brief paper outlining considerations and suggestions for resolving these differences. We did not find these considerations and suggestions appropriate for reporting financial results to Parliament and we wrote back promptly to explain why. We note that references to the CICA Handbook in your 12 March letter were not included in this earlier paper.

As Parliament's auditor, I am very concerned with the change to the government's stated accounting policies that you set out in your letter and I strongly urge you not to make it. My concern is two-fold. First, I believe that the change will open the door for governments to influence reported results by simply announcing intentions in their Budgets and then deciding what to include in the deficit or surplus after the end of the year once preliminary numbers are known. Second, I believe that the change represents a significant departure from objective accounting standards recommended in the CICA's Public Sector Accounting and Auditing Board (PSAAB). I refer specifically to Handbook Section PS3410 that recommends standards of accounting and reporting for transfer payments. Canadian governments and their auditors have worked closely with PSAAB over the past two decades to develop public sector accounting standards in an objective and transparent way. I believe that this approach has led to a strengthening of the credibility of reported financial results by Canadian governments. In my view, the unilateral accounting change that you suggest in your 12 March letter will not only weaken credibility of the federal government's reported results, but will send a signal to other governments that the PSAAB process and recommendations need not be followed.

I am quite prepared and would indeed be pleased to discuss this matter further with your Ministers if you think this might help resolve the matter and avoid continued public confrontation between our offices. I would prefer not to include the proposed chapter in next month's Report to Parliament but unless the government's view changes, I do not see that I have much choice. Your comments and suggestions would be appreciated. I would point out, however, that we must advise the Speaker in the next few days of the contents of our April Report; additional discussions would therefore have to occur quite soon.

I look forward to hearing from you.

Yours sincerely,

L. Denis Desautels, FCA
Auditor General of Canada

Copy: Mr. John Williams
Chairman, Standing Committee on Public Accounts

Detailed Comments by the Office of the Auditor General of Canada on the Government's Technical Arguments Contained in Its 12 March 1998 Letter

Introduction and Purpose

On 12 March 1998, the government presented its rationale for the accounting treatment accorded the transfer payments to the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation. The government also described its view of support for this accounting treatment in professional literature. The purpose of this paper is to provide detailed comments on those professional literature references and related commentary.

Recognition of Transfer Payment Liabilities and Expenditures

The central issue on which we disagree is the point in time at which the government should recognize transfer payments as liabilities and expenditures.

It might be helpful to consider liability recognition in the business world as a point of departure for discussing liability recognition in government. Consider a company that decides to acquire a building. At the time of making this decision, the company is not obligated in any way to make a purchase. It may not yet have selected a specific building or made any deal with another party for the purchase. At this point, there would be no disclosure of the decision on the face of the company's financial statements or in related footnotes. When a formal undertaking to acquire a specific building is in place, a "commitment" is made that would be disclosed in the company's financial statements (in the footnotes). A commitment may be thought of as a contractual agreement to incur a liability. Later, when the company takes title to the building, an actual liability is incurred that would be recognized on the face of the company's financial statements (and removed from the footnotes). In commercial accounting, then, liabilities of this nature are recognized only when suppliers carry out their side of the deal to obligate the purchaser.

The situation in government is not as straightforward. Governments often make what are called "transfer payments" - payments for which no goods or services are received directly by government from the recipients of the payments. Transitional assistance for GST/PST harmonization, funding of the Canada Foundation for Innovation and funding of the Canada Millennium Scholarship Foundation are examples of transfer payments. Because transfer payments are quite different from anything seen in the business world, the Canadian Institute of Chartered Accountants (CICA) Public Sector Accounting and Auditing Board (PSAAB) has developed and published recommended standards that deal specifically with when governments should recognize transfer payments as liabilities and expenditures. This specific Section of the CICA Public Sector Accounting and Auditing Handbook - PS 3410 - is discussed more fully below. One key criterion set out in this Section is that recipients of transfer payments must meet eligibility criteria in order for governments to recognize transfer payments as liabilities and expenditures. This key criterion may be thought of as a surrogate for "suppliers carrying out their side of the deal" - the recognition event that we have in the business world as explained in the preceding paragraph.

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In its 12 March 1998 letter, the government states that it is of the view that support for recording transactions such as funding of the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation can be found in professional literature. The government provides specific references to CICA Handbook Section 1000, *Financial Statement Concepts*, CICA Handbook Section 3465, *Income Taxes* and the CICA's Emerging Issues Committee (EIC) Abstract # 60, *Liability Recognition for Costs Incurred to Exit an Activity (including certain costs incurred in a restructuring)*. Before commenting on each of these references, this paper discusses briefly the application to government of recommendations issued by PSAAB. (Throughout this paper, PSAAB recommendations in the CICA Public Sector Accounting and Auditing Handbook are prefixed with the letters "PS". Recommendations for profit-oriented enterprises are prefixed by the words "CICA Handbook Section".)

The Introduction to PSAAB recommendations states that accounting recommendations apply to all governments unless individual Sections specifically limit their application. PSAAB Accounting Recommendations include PS 3410 on government transfers referred to above. As there are no limitations on its applicability to the federal government, this is the Section that should be used in deciding when transfer payments should be recognized as liabilities and expenditures. The government's current stated accounting policy for transfer payments complies with PS 3410.

As explained earlier in this paper, PS 3410 was developed by PSAAB to address specifically the question of when governments should recognize transfer payments as liabilities and expenditures. Recognition criteria are set out in paragraph 07. This paragraph also states, "Judgment will be required to account for transfers in a manner that best reflects the substance of the underlying events rather than the form or funding pattern." In the case of the payments to the Innovation Foundation and the Millennium Foundation, both of which are grants, it should not be necessary to rely on this "judgment" clause of paragraph 07 because paragraph 38 provides quite precise guidance for recognizing liabilities for grants. Paragraph 38 states, "Liabilities should be recognized by the transferring government for any unpaid, authorized grants at the end of the accounting period for which the recipients have met eligibility criteria, if any, prior to the end of that period." Accordingly, for the Innovation Foundation to have been included in last year's financial statements, it would have had to be in existence and a funding agreement in place by 31 March 1997. Since neither of these conditions was met, we concluded that including \$800 million in liabilities and expenditures last year contravened both objective accounting standards recommended by PSAAB and the government's own stated accounting policies.

CICA Handbook Section 1000 - Financial Statement Concepts

When a specific standard such as PS 3410 exists, it takes precedence over more general guidance such as financial statement concepts. The purpose and scope of CICA Handbook Section 1000 state that it is to be used in exercising professional judgment on the application of generally accepted accounting principles and in areas where accounting principles are developing. CICA Handbook Section 1000 is not to be used to override any accounting principle that is considered to be generally accepted, such as PS 3410 on government transfers. We believe that in PS 3410, PSAAB sets out the criteria to be used to implement the CICA Handbook Section 1000 general liability definition in the specific context of government transfers. Accordingly, the basic principles used to define a liability have already been considered by PSAAB when PS 3410 was developed. We therefore do not believe that it is necessary to look outside PS 3410 for additional guidance on the issue of when the government should recognize transfer payments as liabilities and expenditures. Nevertheless, this paper comments on the other specific Sections of the CICA Handbook that are raised in the government's 12 March 1998 letter.

CICA Handbook Section 3465 - Income Taxes

The reference provided in the 12 March 1998 letter relates to how business firms estimate future income tax liabilities that are already recognized. The concept of “substantive enactment” is only used in the “measurement” part of CICA Handbook Section 3465, and addresses specifically the income tax rate that the firm should use in estimating its income tax liability. Because CICA Handbook Section 3465 deals with *measurement* of income tax liabilities that already exist as opposed to *recognition* of liabilities that do not yet exist, we do not believe that it applies, even indirectly, to the determination of when the government should recognize transfer payments as liabilities and expenditures.

EIC-60 - Liability Recognition for Costs Incurred to Exit an Activity (Including Costs Incurred in a Restructuring)

In its 12 March 1998 letter, the government argues that EIC-60 supports its position to record certain transfer payments as liabilities and expenditures when the decision is made to incur them. In fact, EIC-60 was created to *limit* the costs that business firms could recognize, based solely on management decisions in a year, to those that relate to exiting an existing activity. Specific criteria are provided in EIC-60 that effectively prevent firms from artificially inflating operating results of future years by inappropriately loading costs from those years into the current year. For exit costs to be recognized, they must relate to activities being carried on *prior* to what is called the “commitment date” or to a contractual obligation that existed *prior* to the commitment date. EIC-60 specifically prohibits recognizing a liability at the commitment date for costs that relate to activities that will be continued. Given this background, we do not believe that EIC-60 applies to the determination of when the government should recognize transfer payments as liabilities and expenditures.

Subsequent Events

We agree that objective accounting standards require that events occurring between the date of the financial statements and the date of their completion be considered in finalizing the numbers each year. However, additional information available after the fiscal year end is normally used to confirm or strengthen the valuation or estimate — the *measurement* — of an asset or liability that already exists at year end. Subsequent events are normally not used in deciding what assets or liabilities should be *recognized* at year end. Information in the subsequent period may also be used to provide evidence as to the *probability* of an event having actually occurred as at the fiscal year end. However, this is not relevant to the current discussions because it is a fact that an agreement with provinces to harmonize GST and PST was not in place at 31 March 1996 and we know that the Innovation Foundation did not legally exist at 31 March 1997. Put simply, if a transaction does not meet the definition of a liability as at the end of a fiscal year, no amount of “subsequent events” would change this. For the transactions on which we disagree, there is no “past event” creating a liability at year end; a management decision is not enough.

We have, in prior years, looked to subsequent events to provide evidence for the *authorization* of transfer payments. In cases such as the elimination of the Crow subsidy, eligibility criteria had been met by recipients that existed as at year end and a reasonable estimate of cost could be made as at year end. Government officials proposed, and we agreed, that in situations such as this the enactment of legislation in the subsequent period could be considered in determining whether proper authorization was in place.

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Conclusion

In summary, we have studied the arguments contained in the 12 March 1998 letter and we do not believe that they support the accounting proposed by the government. In our view, PS 3410 provides clear guidance to governments on when transfer payments should be recognized as liabilities and expenditures, and the accounting change proposed by the government does not conform to the recommendations in that Section.

**Office of the Auditor General
24 March 1998**

Report of the Auditor General of Canada to the House of Commons – 1998

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